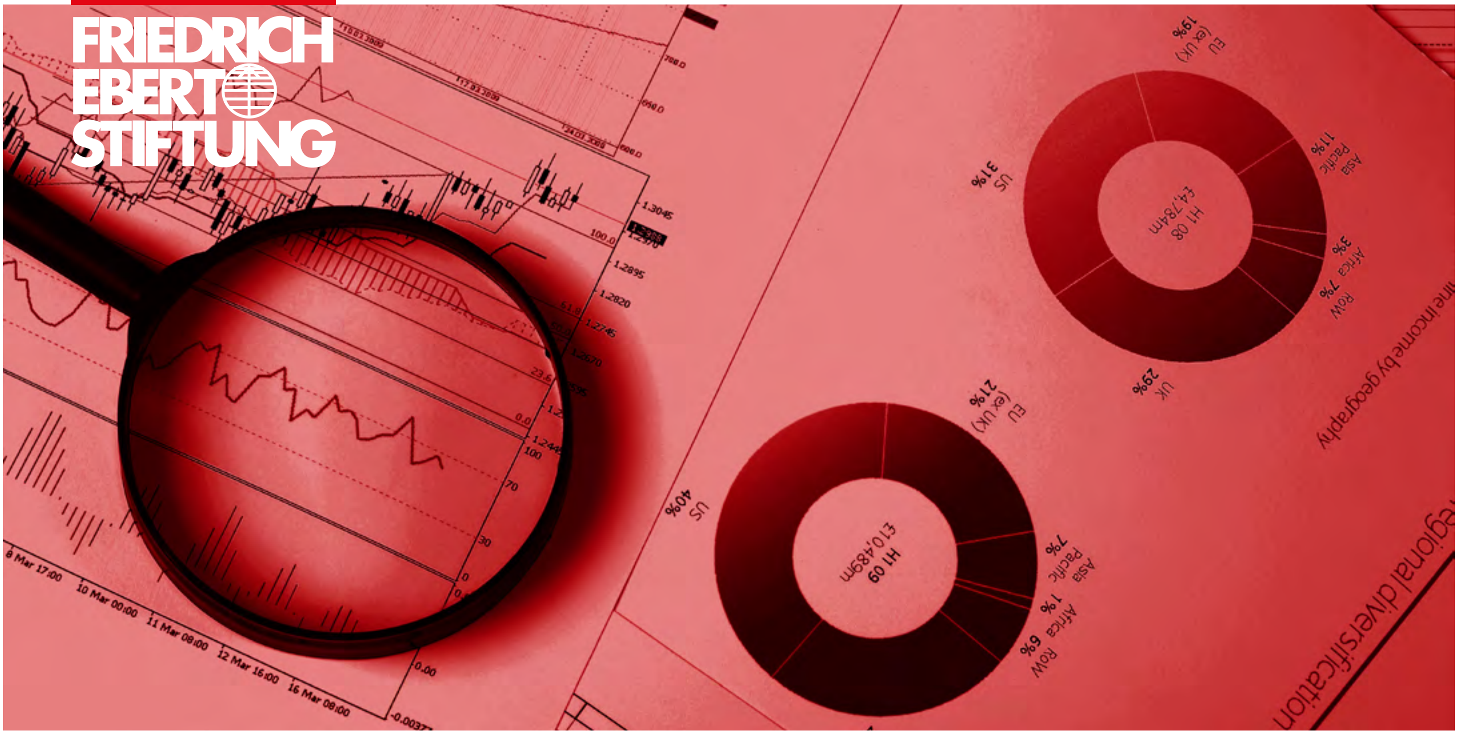

Max Brändle and Michael Weichert (Eds.)

A New Economic Agenda for Southeast Europe

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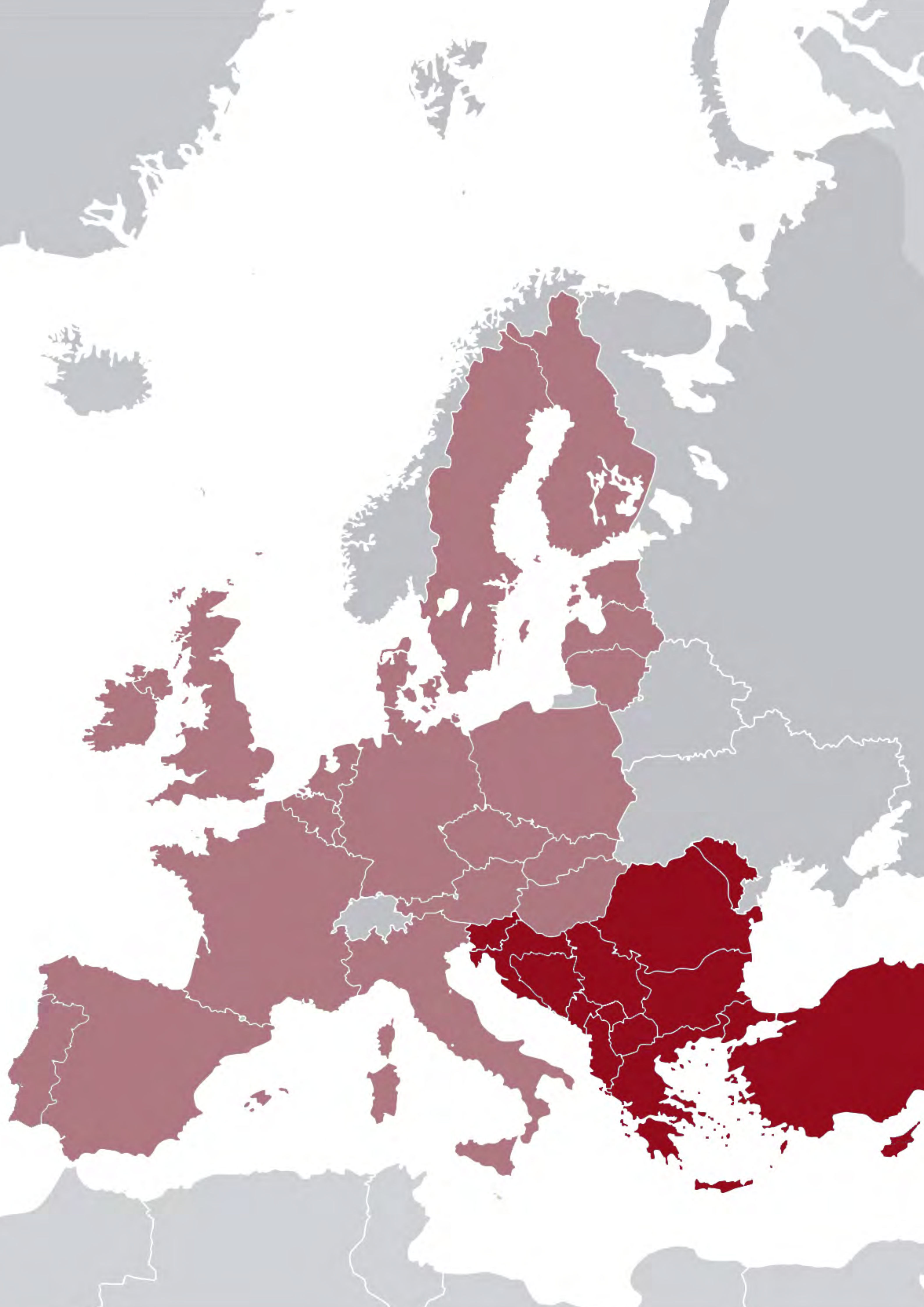
SOE Dialog Südosteuropa



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A New Economic Agenda for Southeast Europe

Zagreb 2018

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A New Economic Agenda for Southeast Europe

Policy Recommendations

Jens Bastian and Max Brändle

1. Introduction

1.1 The New Economic Agenda Working Group

This volume is based on the work and discussions of a working group that has gathered with the assistance of Friedrich-Ebert-Stiftung. Its aim was to describe the economic challenges and solutions towards more sustainable, qualitative and inclusive growth for Southeast Europe. The development gap towards Central Eastern Europe as well as towards the EU average remains huge. In order to bridge this gap, the Wester Balkans need to make better and more differentiated use of foreign direct investments, the EU has to devise its funds for the region in a more targeted and sustainable way, the governments of the region have to develop industrial policies for their respective countries as well as for the region as a whole, and, finally, the instruments of monetary and fiscal policy have to be revised.

This paper presents central insights of our deliberations and provides concluding policy recommendations which are based on the discussion this working group, a circle of economists, sociologists, and political scientists from Southeast Europe and Germany. This working group has met on several occasions since the end of 2015 until the spring of 2018 in Zagreb, Skopje, Ljubljana, Bucharest and Sofia on the invitation of Friedrich-Ebert-Stiftung. One important point of the project was that there is no 'one size fits all'-solution for the economic and social challenges of the countries in Southeast Europe, there is not one medicine that is the panacea for all problems of the region. We rather started from the insight, that the usual medicine of neo-liberal economic policy measures did not deliver the intended results in the respective countries.

Therefore, we decided to dig deeper empirically and recalibrate the conceptual emphasis. Five county studies with a focus on Bulgaria, Croatia, Macedonia, Serbia and Slovenia, as well as two regional studies, one for Southeast Europe and the other on Central Eastern Europe, have been written in the process; these studies are published together with this paper in book form by Friedrich-Ebert-Stiftung. This paper is not a manifesto of the New Economic Agenda-working group; it rather presents key findings, points out policy recommendations and wants to have an impact on the debate about European integration of Southeast Europe. It does not necessarily reflect the opinion of all the individual experts and authors involved in the project.

The Friedrich-Ebert-Stiftung would like to thank all the experts who have contributed to this process: Franz-Lothar Altmann, Mihail Arandarenko, Jurij Bajec, Jens Bastian, Max Brändle, Vladimir Cvijanovic, Milan Cvikl, Gancho Ganchev, Vladimir Gligorov, Velibor Mačkić, Jože Mencinger, Jelica

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1.2 Sustainable, Qualitative and Inclusive Growth for Southeast Europe

Various countries in Southeast Europe are currently witnessing their fastest economic expansion for nine years. Romania grew 8.8 per cent year on year in the third quarter of 2017, primarily based on increased government spending on pensions and rising public sector salaries which stoked a boom in private consumption. Serbia's economy is projected to grow by three per cent in 2017. The economic growth forecast for Macedonia was 1.9 percent in 2017 and 3.2 percent for 2018. In Kosovo, annual output growth reached 4.4 per cent in the third quarter of 2017 and Bosnia and Herzegovina grew at 2.9 per cent. Montenegro grew at a robust 4.7 per cent while annual GDP in Albania was forecast at 3.5 per cent.

Still, as impressive as the quarterly GDP numbers appear, the economic recovery is fragile, constrained to specific sectors, while unemployment remains high and a lending recovery by commercial banks has yet to expand from large enterprises to medium and small-sized businesses. After a prolonged and difficult transition path from the late 1980 until the economic crisis, the countries in Southeast Europe are not yet on a development path which guarantees future socio-economic prosperity. Limited competitiveness on world markets, jobless growth, increasing social problems and the consequences of extreme deindustrialization remain key structural problems of the region.

Furthermore, economic growth is by no means a guarantee of social cohesion. Social protection systems across Southeast Europe are fragile and unable to offer an adequate safety net against risks such as unemployment, disability and again, let alone be a springboard to social and economic reintegration. Rather than just strive for increased economic growth, the countries of the region should aim for a more balanced model of development and implement redistributive policies that can combat mounting social problems and secure decent living standards. The good news is that growth is back in Southeast Europe. But this alone is not the solution to the economic and social challenges. What the countries in Southeast Europe, and especially the Western Balkan EU candidate and association countries need is sustainable, qualitative and inclusive growth.

1.3 Breaking the Power of Patronage Networks

After years of democratic stagnation in the Western Balkans, the new Macedonian government that took office in May 2017 constituted the first democratic transfer of power in the region after four years. It also represents a break with the success of autocratic rule. The Macedonian moment stands out and has the opportunity of setting an example. The subsequent improvement of the Bulgarian-Macedonian relations further nourishes this hope. New ideas, progressive leadership and genuine vistas for countries in the region need to come forward as a change of political culture in the Western Balkans. Without doubt, the transfers of power focus not only on individuals and their ability to deliver. Breaking the power of patronage networks is essential as they constitute the main transmission channels between politics and citizens across the region. Thus, structural change in politics is about making government more transparent and accountable. The renewal of democratic rule in various Balkan states remains a work in progress which will require joint efforts at the domestic level and EU mediation, social movements and protests as well as international efforts.

1.4 Re-Energize the EU-Enlargement Process

The European Commission presented a strategy paper in February 2018 which aims to jump-start the stalled EU-accession processes in the Western Balkans. EU enlargement has always been promoted as a driver of domestic reform capacity. The roadmap of accession now includes a timetable for 2025 – in the best case – for front running countries such as Serbia and Montenegro. This seems like a last chance for the EU to present a clear road-map for the European integration of the Western Balkans. It has to be a clear objective of the EU to leave no country behind.

The prospect of EU membership must not only be a driver for domestic reform, but also for more intensive regional cooperation, also in the areas of research and development, energy, transport, agriculture and for a regional industrial policy. The initiative for a Regional Economic Area is a step in the right direction. A failure of this path towards EU integration, or an excessively slow pace of enlargement raises the question of geopolitical competition in the region with Russia, Turkey, China and the Gulf Arabs as actors with their own interests in Southeast Europe.

It is encouraging to see that the EU's renewed enlargement policy is now based on three pillars, namely public administration, the rule of law and economic governance. The deterioration of democratic standards and attacks on the independence of the judiciary in some countries of the Western Balkans cannot be further ignored by policy makers in Brussels. But unless the new Enlargement Strategy can contribute to enhance fragile economic growth and improve social progress in the region, it risks being seen by many as yet another futile institutional exercise.

2. Policy Recommendations for Sustainable, Qualitative and Inclusive Growth

2.1 The Role of Foreign Direct Investment (FDI) in Supporting Sustained Growth

The economic recovery in Southeast Europe continues to be fragile and susceptible to pushbacks. It is therefore risky to merely assume that it is a matter of time until foreign investors will return to the region. FDI cannot per se be considered an investment in real assets. The track record of FDI (greenfield and privatization-related) is mixed at best. FDI can be a welcome supplement to the still low domestic savings, but it is unlikely to be sufficient for a faster and sustained economic development. Based on the experience of FDI during the past two decades, governments need to refine their investment promotion strategies and find a more balanced approach.

- Governments in Southeast Europe need to attract not only more, but also **better-quality investments** which facilitate a faster restructuring and technological upgrading of key industries on the basis of a systematic industrial policy, institutional reforms and taxation.

- The countries' investment policy should also influence the **sectoral distribution** and should extend across sectors of agriculture, energy, R&D, education and innovation. Such a targeted industrial policy will help to diversify and upgrade the production and export base. The targeting needs to be undertaken by investment promotion agencies to direct greater FDI flows into chosen sectors by the host economy and in higher unit-value exports.

- Countries in the region need to improve their export capacity and attract foreign direct investment. To the extent that **China, Russia, Turkey or Gulf states** are willing to provide such resources, many countries in the region will see therein opportunities and choices, while tending to downgrade the **perception of risks**. It is important to see that the growing trade deficits of countries in Southeast Europe with China and rising lending dependency from state-owned Chinese policy banks for infrastructure projects do not necessarily constitute a 'win-win' combination for all parties involved. Moreover, such a pivot towards Beijing must comply with rules and regulations that are based on the priorities of the European Union accession process for countries in the Western Balkans.

2.2 The Role of EU Funding and International Financial Institutions (IFI)

Foreign Direct Investment can only be one source of financing for Southeast Europe. Resources from the European Union and International Financial Institutions (IFI) will remain one of the most important instruments for the social and economic development of Southeast Europe. The focus on Economic Governance in the EU's enlargement strategies puts major importance on the problems of economic development which had been in the shadow of political issues for a long time.

- The recently introduced **Economic Reform Program (ERP)** can help to move West Balkan governments to adopt a longer (three-year) planning framework and to introduce prioritized structural objectives based on an impact analysis of desired outcomes. However, only few countries have for now the administrative capacity to actually undertake this type of longer-term policy planning. Here further assistance by the EU is needed.

- The Western Balkan countries should be supported with additional financial resources form the EU and its institutions before they actually enter the EU. **Access to the EU's structural funds** should be granted **before membership**. This will help the candidate and aspirant countries to boost their public investment and adopt a clearer development perspective. Eventually, this would be beneficial economically and geopolitically, not only for the Balkans but also the EU itself.

- For **EU member states** such as Bulgaria, Romania, Slovenia and Croatia the **utilization of EU funding instruments** may become more difficult under the newly established EFSI 1 and EFSI 2 arrangements of EU cohesion policy. The set of rules applicable to EFSI operations with the establishment of prior actions such as *Investment Platforms* and *National Promotional Banks* are complex and require institutional preconditions that are ambitious. Investment projects will require to be pooled with a thematic or geographic focus. The provision of EIB loans will require guarantees, counter-guarantees and capital market instruments as funding or credit enhancement. This conditionality, while appropriate in terms of risk management, presupposes a level of preparation and sophistication in financial engineering instruments that may prove challenging for participating ministries, banks and project applicants.

- The **role of International Financial Institutions** is critical in that respect, not only in terms of their operational mandate as a lending institution. The EBRD, World Bank, Central European Initiative (CEI), EU Delegations and the Regional Cooperation Council (RCC) can provide valuable input in the strategic advisory areas: (i) the promotion of good governance, (ii) public procurement transparency, and (iii) expanding the financial role and responsibility of the private sector in combination with the utilization of EU-related financial engineering instruments.

2.3 Providing Credit to the Real Economy

As a transmission channel to the real economy, the banking sector has an essential role to play with the provision of affordable credit at reasonable (time) maturities and sustainable yield levels. This responsibility has frequently been called into question in numerous countries of the region during the past decade, in particular since the outbreak of the financial crisis in 2008. Corporate financing still heavily relies on bank-centered lending. Given the elevated levels of non-performing loans in various countries of the region, credit availability remains difficult and the provision of quality collateral is a major challenge for many companies, in particular SMEs and start-ups.

The Western Balkan countries do not lack innovative business ideas or a risk-taking attitude. But they are frequently excluded from a funding pipeline that continues to focus on large enterprises, excessive-collateral requirements and short repayment maturities at high interest rates.

- The **pro-active involvement of the European Investment Bank (EIB)** in countries of the region is an important measure, but a revival in responsible lending will need more than the initiatives of the EIB, the EBRD or foreign-based micro-credit institutions. Stronger credit growth to the non-financial sector requires policy interventions to reduce NPL levels of SMEs. Targeted lending schemes for start-ups whose credit history with domestic commercial banks is insufficient need to be part of this conversation.

- The **'Juncker Investment Program'** (EFSI 1 and EFSI 2) **should be extended to accession and candidate countries**. The net capital inflow via EU structural funds can contribute to keeping growth rates in or closer to positive territory. But it is not a one-size fits all solution. Participation in the *'Juncker Investment Program'* should be open to public and private sector initiatives.

2.4 Industrial Policies with a Focus on Innovation and Human Capital

Policy-makers in the Western Balkans need to elaborate and implement a more efficient industrial policy, both at the national and regional levels. Industrial policies need to be country-specific, carefully prepared by its advocates on the basis of national priorities. The country studies of this project have shown that an explicit government-sponsored and targeted industrial policy does not even exist in several countries.

- A **regional industrial policy** calls for coordinating national policies in agreed priority areas, all the more since it can establish economies of scale and create a critical mass of initiatives. Greater regional cooperation in industrial policy-making should focus on the sectors energy, transport, tourism, agriculture, as well as on R&D and start-up companies.

- The **focus on innovation** is crucial for all countries of the region. The Bulgarian government, e.g. adopted the *Concept for Industry 4.0* in 2017. Innovation promoting strategies must become part of a wider policy framework that would include education, the development of skills for young people through vocational training, and close cooperation between higher education institutions and the business sector.

- The **Regional Cooperation Council (RCC)** in Sarajevo is a key institution to advance and promote such an industrial policy agenda. Its 'SEE 2020 Strategy' was adopted in November 2013 and represents the attempt to implement targeted regional cooperation initiatives in different sectors of the countries' economies, in particular transport and energy.

- Equally, the Berlin Process launched in 2014 includes the establishment of a **Regional Economic Area** in the Western Balkans. Such an emerging institutional architecture and the political will articulated therein represent opportunities to include the advocacy of industrial policy making for individual countries and the region as a whole.

2.5 Southeast Europe Needs a System of Well-Governed Development Banks

The debate about industrial strategy in countries of Southeast Europe needs to embrace innovative financial sector initiatives. One such avenue concerns the advocacy of development or promotional banks. Such financial institutions require a specific set of legal and regulatory conditionalities attached to their operational mandate. Revolving loan or credit funds have been used to support government operations across Europe. The *Juncker-Plan* at the European Union level or promotional banks such as the KfW in Germany, the CDC in Italy, the EIB in Luxemburg and the EBRD in London highlight an expanding architecture of development banks and strategic public investment funds across the continent. By contrast, such financial institutions are in high demand, but low supply in the region of Southeast Europe.

- The **Western Balkans need a system of development banks** as part of coordinated efforts to direct investments in Southeast Europe. Such national policy institutions seek to mitigate credit crunches, e.g. in sectors where access to loans from commercial banks is constrained by collateral requirements, high interest rates and short maturities, in particular for SMEs and start-ups.

- Engaging in building financial development institutions requires astute attention to its **governance mechanisms**. Key among promotional banks must be to ensure their **independence from political interference and cronyism**. The definition of these preconditions is all the more necessary as there is a legacy of past development banks that have frequently served as vehicles for rent-seeking politicians, were prone to corruption and provided political lending while ignoring the viability of applicants' business plans.

- The advocacy of promotional banks will also require **blending such financing instruments with private sector initiatives**, e.g. public-private initiatives (PPPs). The concrete instances and mechanisms of cooperation and hierarchies between promotional banks and PPPs will require detailed elaboration and attribution of legal accountability, e.g. to central banks and parliament. Constraining development banks by capital market actors or narrow political considerations is not the rationale for their advocacy.

2.6 Optimize Monetary and Exchange Rate Policies

The countries in Central, Eastern and Southeastern Europe illustrate a large mixture of monetary policies which they have implemented since the 1990s. Across this set of countries, every type of monetary and exchange rate regime can be identified. This multiplicity includes inflation targeting, floating regimes, currency pegs, membership in the euro area and the unilateral introduction of the euro.

At times the focus was on controlling runaway inflation, other periods and countries based their monetary policy on the management of income convergence with Western Europe and cyclical needs. But even flexible regimes in this region experienced their own boom-bust cycles during the period 2003–2013. The continued existence of fixed-exchange rate regimes in some countries points to lasting credibility challenges for domestic currencies.

Central banks have little room for maneuver when ongoing pegs lead to high deposit and loan euroization. Tying the domestic currency to an anchor currency such as the Euro may provide stability in monetary affairs, but limits policy makers leverage for fine-tuning. Monetary policy is further disabled when economies in the region have high foreign currency exposure. Any depreciation of the nominal exchange rate risks increasing the accumulated debts of the corporate sector and private households, with subsequent knock-on effects on investment capacity, consumption and disposable income levels.

- The balance of benefits and risks of various **exchange rate regimes must take country characteristics into consideration**. It remains a huge challenge for countries with a fixed-rate regime to identify the appropriate timing and process to transition towards greater flexibility. Bulgaria is the obvious case in point. But similar challenges loom for policy makers in Serbia and Croatia. Uncontrolled shifts should be avoided, and any revised strategy must contain monetary and financial stability.

- In order to avoid monetary misalignments implementing a combination of countercyclical fiscal and macro-prudential policies will require the **close coordination of finance ministers and central bank governors** in individual countries of the region.

3. Inequality, Employment and Social Cohesion

3.1 Leave No One Behind

The good news is that growth is back in Southeast Europe, but growth alone by no means guarantees social cohesion. Past periods of growth have rarely undone the damage to the social fabric caused by the shocks of transition, conflicts and recession. Growth has often not only been jobless but contributed to increasing inequalities: between income groups, between regions, and between generations. Social protection systems across the region remain fragile. Inclusive and effective social policies have to be considered as a productive factor with a positive impact on economic growth and development. Repairing the social fabric across the region requires bold policies as part of a new social contract. No Economic Agenda for the region can be considered complete without an explicit focus on policies to reduce (income) inequalities, create quality employment for all, improve social dialogue, and reduce social exclusion.

3.2 Tackling Rising Inequalities

Rising inequalities across the region pose a serious and continued threat to social cohesion. Horizontal inequalities, including unequal access to opportunities for women, minorities, and people with disabilities add to the challenges. In addition, growth has tended to favour larger urban cities at the expense of peripheral and rural areas and some regions in the Western Balkans have become zones of exclusion. The following policies should therefore be considered to tackle rising inequalities:

- The region's experimentation with low and flat income tax rates, often combined with high taxes on consumption needs to be replaced by a more flexible set of taxation policies including **progressive income tax** and the development of **progressive property taxes** alongside takes on wealth and inheritance. The overall tax burden on the bottom quintile group can also be achieved by lower rates of VAT on essential commodities including food.

- Entrenched rural-urban and regional inequalities need to be reduced through **sustainable regional development policies** which target disadvantaged areas for a range of programmes including: subsidies for essential service workers in health, education, channeling of investments to disadvantaged areas, support for agriculture.

- Access to free or **affordable and quality preschool education, education, and health services for the poorest** quintile of the population must be a priority. An extensive system of grants for those from poor families wishing to attend higher education is also important.

- **Increased opportunities for women**, national minorities, people with disabilities and LGBTQ identified persons needs to be part of the equality agenda both in terms of legal provision, the rigorous enforcement of anti-discrimination provisions and the development of inclusive labor markets.

3.3 A Decent Work Agenda

Unfavorable labor market features are a challenge to inclusive economic growth, development and social cohesion in Southeast Europe. Employment and activity rates are low by EU standards and, with some exceptions, stagnating. Two main groups have dramatically low employment rates across the region: young people and women. The quality of employment is also a serious issue in a region marked by high rates of activity in the informal, and hence unprotected, real economy and in the emerging non-standard economy characterized by precarity and short-term contracts or a misleading definition of work as self-employment. Social dialogue is underdeveloped across the Western Balkans and Southeast Europe, not least as a result of the weakening of the bargaining power of trade unions and the proliferation of firm-level agreements.

- The countries of the region need to devote a significantly higher proportion of GDP to **Active Labor Market Policies** targeting disadvantaged young people, women, minorities, and older workers. Active Labor Market Policies need to become more flexible and responsive to diverging needs across the region, prioritizing skills enhancement and the building of human capital. To boost the employment of women, it will be necessary to change the regulatory environment and to invest much more in services and benefits which promote work-family life balance.

- **Trade Unions need to be key players in social dialogue** and economic governance in all key sectors. At the same time, the voice of civil society is needed to ensure that the interests of those not in formal employment are represented, and a sustainable balance between economic, social and environmental objectives is achieved. Social dialogue is crucial to ensure that leading companies operate across the region with a growing sense of corporate social responsibility and are committed to reduce their environmental footprints.

Towards A Sustainable Economic Growth and Development in the Western Balkans

Milica Uvalić and Vladimir Cvijanović

Executie Summary

- Since the beginning of the transition to a market economy in 1989, the Western Balkan (WB) countries have faced particular difficulties in economic development, under the impact of the breakup of SFR Yugoslavia, military conflicts and international sanctions, thus delaying important economic and institutional reforms as well as integration with the European Union.

- During the 2001–2008 period there was a general improvement in macroeconomic performance of all Western Balkan countries, especially among those lagging behind witnessed: an acceleration in GDP growth, declining inflation, a fast rise in foreign trade, substantial FDI inflows and the implementation of many transition-related economic reforms.

- The global financial and economic crisis severely hit the WB countries through two main channels – a drop in export demand in foreign (mainly EU) markets and the abrupt reduction in foreign capital inflows (foreign loans, FDI, donors' assistance, workers' remittances). Thereafter, most WB countries experienced a deep recession or a notable GDP slowdown (Albania, Kosovo), followed by a period of prolonged stagnation or repeated recessions and a very gradual economic recovery.

- The multiple economic crises in the WBs after 2009 brought to the surface many structural problems: serious external imbalances deriving from high trade and current account deficits, essentially caused by insufficient competitiveness on foreign markets; mounting social problems, also due to the highly unsatisfactory situation on the labour markets; extreme deindustrialisation along with a fast expansion of services (banking, telecommunications, retail trade, real estate) that primarily serve the domestic market, thus contributing only indirectly to the development of the tradable goods sector and improved external competitiveness.

- The macroeconomic situation in the last few years has somewhat improved (gradual economic recovery, low inflation, some fiscal consolidation, lower current account deficits), but current economic policies are severely constrained – monetary policy by rigid exchange rate regimes and the high degree of euroisation of the WB economies, fiscal policies under strict EU surveillance.

- Moreover, the structural weaknesses of the WB economies have not been removed. In comparison with the Central East European and the Baltic (CEEB) countries, the WB countries are today less developed, less competitive and less

integrated into the global economy; most countries still have extremely high unemployment rates and low employment rates; and they are more de-industrialised than even some of the older, and most of the newer, EU member states.

- The WB countries should aim at implementing a model of development that balances economic, social and ecological aspects. Key issues to be addressed in the future, through more efficient industrial policies and development strategies, include agriculture, energy, R&D (human capital) and public administration reform.

1. Introduction

Although the transition to a market economy and multiparty democracy in the Western Balkan (WB) region started in the late 1980s, in comparison with countries in Central and Eastern Europe and the Baltics (CEEB), most WB countries are today lagging behind in their level of economic development, economic and institutional reforms, and integration with the European Union (EU). The aim of this paper is to offer tentative answers to some fundamental questions regarding the WBs' economic development. Why have the WB economies performed worse than those in CEEB? Why are they still so underdeveloped? Why have similar policy prescriptions regarding the transition-related economic reforms had much more limited results in the WBs than in CEEB? The analysis of a quarter of century of transition should also point to possible remedies, namely more appropriate policy options for the WBs in the future.

We will consider the region in its narrow definition of the Western Balkan (WB) states— Albania, Bosnia and Herzegovina, former Yugoslav Republic (FYR) of Macedonia (hereafter Macedonia), Montenegro, Serbia and Kosovo. However, we will also add Croatia and refer to the whole group as the WBs.[1] Although Croatia became the 28th EU member state in July 2013 and therefore is no longer part of the WBs, it will be included in the analysis since its experience before joining the EU is very relevant for the economic problems of the other WB countries. In discussing the pre-1989 period, Slovenia will also be considered, since it was one of the republics of SFR Yugoslavia.[2]

In order to understand the starting conditions in the WB region, the paper will first give a short overview of the economic developments before 1989 (section 1). The main political and economic problems encountered by the WB countries after 1991 are then addressed, pointing to the main factors that have impeded a faster implementation of the transition during the 1990s (section 2). The principal achievements and failures of economic policies during the new millennium are then highlighted, both during the years of relative prosperity (2001–2008) (section 3) and the years after the global crisis (section 4). The main structural problems of the WB economies, that came to the surface after the 2008 economic crisis, are also discussed (section 5). The economic situation in the WB countries today is analysed in some detail, pointing to specific macroeconomic constraints (section 6). The key policy failures in a longer-term context are stressed, as well as some areas that need to be included in future strategies of economic development (section 7). The main conclusions and policy recommendations are given at the end (section 8).

2. The Western Balkans prior to 1989

On the eve of transition to multiparty democracy and a market economy, the general situation in the Western Balkan region was very different from what it is today. The region consisted of only two countries: the Socialist Federal Republic (SFR) of Yugoslavia with its six republics and Albania. SFR Yugoslavia was a much larger country in terms of territory and population, it had a much higher GDP per capita, it experienced various market-related economic reforms, developed a unique system of workers' self-management and implemented substantial decentralisation of its economy, particularly after 1974. Moreover, after the Tito-Stalin conflict in 1948 SFR Yugoslavia developed specific international relations which placed it somewhere between the

1 There have been a number of statehood changes over the past 25 years. Five states were created immediately after the disintegration of the Socialist Federal Republic (SFR) of Yugoslavia in 1991: the Federal Republic (FR) of Yugoslavia, constituted in April 1992, consisting of Serbia with its two provinces, Vojvodina and Kosovo and Montenegro; Bosnia and Herzegovina; Croatia; Former Yugoslav Republic of Macedonia; and Slovenia. FR Yugoslavia changed its name into the State Union of Serbia and Montenegro on 4 February 2003; and after the May 2006 referendum on independence in Montenegro, Serbia and Montenegro became two independent states in mid-June 2006. Kosovo officially remained part of Serbia, according to the UN Security Council Resolution 1244 adopted in mid-1999, though effectively it was governed by UNMIK thereafter; in February 2008 Kosovo unilaterally declared its political independence. All statistics after 1999 on FR Yugoslavia/Serbia do not include data on Kosovo.

2 After its independence, Slovenia shared many features of the Central East European (CEE) countries and therefore has most frequently been considered as part of the CEE region.

East and the West,[3] enabling its increasing trade orientation primarily towards the OECD countries (in 1990, 59,8 percent of its exports and 63,7 percent of its imports were to and from developed countries).[4] SFR Yugoslavia also had a more liberal political regime despite retaining a one-party system: the League of Communists was highly decentralised to facilitate political decision-making in its six republics, and its citizens had more individual freedoms than elsewhere in Eastern Europe.[5] By contrast, in 1989 Albania was the least developed country in Europe. After leaving the Council for Mutual Economic Assistance (CMEA), it pursued, for decades, a specific autarkic development strategy idealising national self-reliance as the main orientation of its economic policy. Consequently, in 1990, Albania was the most closed economy in Europe. At that time, it still had a rigorously centralised economy based on the traditional system of central planning (see Muco, 2001). In contrast to the Yugoslav successor states that in 1991 inherited elements of the market mechanism, Albania had no previous experience of a market economy. Albania also had one of the most authoritarian political regimes in Eastern Europe.

SFR Yugoslavia started its transition in the late 1980s with a burden of severe economic problems. Until 1979, the Yugoslav government implemented an ambitious economic growth strategy based on high investment rates and relying increasingly on external borrowing (Uvalic, 1992).[6] Structural weaknesses emerged due to insufficient investment in crucial sectors (energy, raw materials), parallel with excess capacity in other sectors and the duplication of plants across regions. After Yugoslavia was no longer able to service its external debt, a stand-by arrangement was concluded with the IMF in 1980 and the austerity packages implemented thereafter led the economy into a deep recession. The economic crisis persisted throughout the 1980s, culminating in hyperinflation in 1989 (Uvalic, 1992). The political crisis within the Yugoslav federation after Tito's death in 1980 brought the regional issues to the fore, which gradually drifted out of control by the end of the decade (Estrin and Uvalic, 2008).[7]

The first steps to fundamentally change the economic system in SFR Yugoslavia were taken in 1988 when Amendments to the Constitution raised the limits on private property and encouraged FDI. In December 1989, the Federal government launched a bold macroeconomic stabilisation programme based on "shock therapy".[8] These economic reforms were interrupted by a series of disputes between the republics for both economic and political reasons, which soon after led to Yugoslavia's break up. At the same time, the dissolution of the League of Communists of Yugoslavia in January 1990 led to the emergence of new political parties and the first free multiparty elections, which took place from April to December 1990 in all the Yugoslav republics.

Despite the complex situation prior to SFR Yugoslavia's break-up, there is no doubt that its successor states had better initial conditions[9] than the centrally planned economies in Central and Eastern Europe (Uvalic, 1992). Kekic (1996: 5–22) calculated an index of initial conditions in 26 communist countries in the late 1980s, showing that the index was lower for Bulgaria (13), Albania (15) and Romania (15) than for the Yugoslav republics (19 for Serbia and Montenegro, 20 for Macedonia, 22 for Croatia and 24 for Slovenia). Within SFR Yugoslavia, there were major differences among its six republics regarding most economic indicators, but the institutional set-

3 SFR Yugoslavia did not join the Council of Mutual Economic Assistance (CMEA) in 1949 (though it participated after 1964 in some of its standing committees) nor was it part of the Warsaw Pact; together with Egypt and India it founded the non-aligned movement in the late 1950s. It was also a founding member of the International Monetary Fund and the World Bank in 1944 and participated actively in the various rounds of the General Agreement on Tariffs and Trade (GATT). SFR Yugoslavia was an associate member of the OECD (the first OECD Economic Survey of SFRY was published in 1963) and it had a privileged relationship with the European Community – from the early 1970s through various trade agreements and benefiting from the Generalised System of Preferences; and since 1980 through a Cooperation Agreement which besides trade regulated other important fields of cooperation, including financial assistance, energy, transport and technology; see Uvalic (1992), p. 9.

4 In 1990, within the group of "developed countries", 45,8 percent of SFR Yugoslavia's exports went to the European Economic Community (EEC) and another 6,8 percent to the European Free Trade Association (EFTA) countries, while 44,3 percent of its imports were from the EEC and another 9,9 per cent from the EFTA countries; the rest was trade with the US and other developed countries; calculated from data of Savezni zavod za statistiku, 1991, p. 319.

5 For example, after 1965, Yugoslav citizens were free to travel abroad with passports that were issued for a period of five years (Uvalic, 1992). Moreover, visas were not required at that time to travel to any West European country.

6 Yugoslavia's external debt increased from less than 2 billion US dollars in 1970 to 14 billion US dollars in 1979 and, following the second oil shock, to US 18 billion US dollars in 1980 (based on official Yugoslav statistics, in Uvalic, 1992, p. 10–11).

7 For a very interesting empirical analysis of economic development in SFR Yugoslavia and its successor states throughout the 1952–2013 period, see Bicanic et al. (2016).

8 As a response to hyperinflation, the "shock therapy" was based on the pegging of the exchange rate to the German mark, the introduction of resident convertibility, freezing of money wages, strict monetary control, liberalisation of 75 per cent of prices (except for public utilities, some metals and pharmaceuticals) and liberalisation of 95 per cent of imports. A privatisation law was also adopted in December 1989 (Uvalic, 1992).

9 The index was calculated taking into account various indicators, including GDP per capita, dependence on CMEA trade, external debt, energy intensity, economic structure and general government expenditure.

up was similar (Uvalic, 2010). All the Yugoslav successor states inherited some elements of the market mechanism and the system of self-management, but also features typical of the socialist economic system, well described by Janos Kornai (1980) (e.g. state paternalism, soft-budget constraints, an over-investment drive) (Uvalic, 1992).

After the break-up of the Yugoslav federation in mid-1991, the speed of the implementation of transition-related economic reforms varied considerably. One might have expected that the extent of market-oriented reforms undertaken in the past, which gave all the Yugoslav successor states some of the best initial conditions, would have facilitated the transition; but instead of being the leaders among transition countries, most of them have turned out to be laggards (Estrin and Uvalic, 2008). The rest of this paper will try to further highlight why this was so. In reality, Yugoslavia's successor states inherited from SFR Yugoslavia not only institutional advantages, but also important disadvantages, primarily very complex political problems that would lead to a whole decade of extreme political and economic instability.

3. Delayed Transition in the Western Balkans during the 1990s

Three groups of inter-related factors explain the WB countries' delay in the transition to a market economy during the 1990s (Uvalic, 2012): (1) the political events of the early 1990s, which had profound economic consequences; (2) inappropriate economic policies, including the neglect of important transition-related economic reforms; and (3) limited EU measures to facilitate the transition in the WB countries, thus postponing their economic (and political) integration with the EU.

(1) In the early 1990s, the WB region was negatively affected by several institutional shocks: the break-up of the Yugoslav federation, the accompanying military conflicts and the transition to market economy. All the Yugoslav successor states were directly or indirectly involved in military conflicts – Slovenia (1991), Croatia (1991–95), Bosnia and Herzegovina (1992–95), FR Yugoslavia (1998–99) and Macedonia (2001). In addition, FR Yugoslavia was under severe UN/EU sanctions during most of the decade (in 1992–96 and again in 1998–99), while Macedonia was under the Greek embargo.

The highly unstable political conditions in the WB region had very profound economic consequences. As elsewhere in Eastern Europe, the early transition-related economic reforms also in the WBs brought high inflation, a substantial fall in real GDP, a rise in unemployment and the worsening of other social indicators, but in the successor states of former Yugoslavia these problems were much more pronounced than in Albania or the CEEB countries (Uvalic, 2012).

(2) These political events had a very negative impact on economic performance of most WB countries. Albania's stabilisation efforts were relatively successful after the implementation of its shock therapy stabilisation program in 1992, backed by an IMF stand-by arrangement. Despite the financial crisis in 1996-98 due to the crash of pyramid schemes that again provoked inflationary pressures, from 1999 on inflation has been low. On the contrary, the successor states of former Yugoslavia initially gave priority to the political agenda. Most countries faced extreme macroeconomic instability due to the break-up of the Yugoslav political, economic and monetary union, fuelled further by expansionary fiscal and monetary policies related to the military conflicts. Inflationary pressures were substantially reduced in Croatia and Macedonia already in 1994 and 1995, respectively, but in FR Yugoslavia only in 2001–02.[10] The Yugoslav successor states also went through a deeper and longer recession than the CEEB countries (or Albania); and all countries except Bosnia and Herzegovina again experienced negative growth in the second half of the 1990s. Due to a very poor growth record during the 1990s, the process of economic recovery of the pre-transition level of real GDP has been much slower in the WBs than in the CEEB countries (see below).

Yugoslavia's break-up had a disruptive effect on foreign trade, which remained unsatisfactory also in the second half of the 1990s. The WB countries attracted very limited Foreign Direct Investment (FDI), which mainly went into the services sector and prevalently into Croatia (Estrin and Uvalic, 2014). After 1995, the war-affected WB countries did receive substantial donors' assistance, but this caused an acute problem of "aid addiction" – transfers of large amounts of international resources without the creation of sound conditions for more permanent self-sustaining growth (see Kekic, 2001). Until 2000, the dominant part of foreign/EU aid in the Balkans was used not for investment, but for consumption – emergency programs, humanitarian assistance and food aid (Uvalic, 2010, p. 221).

The 1990s also brought increasing social problems to the WBs – high unemployment, the flourish-

10 FR Yugoslavia experienced extreme monetary instability in the early 1990s: in 1993 it had the second highest and second longest hyperinflation ever recorded in economic history, of 116.5 trillion percent (Uvalic, 2010, p. 56).

ing of the informal economy and substantial social differentiation. As in CEEB, rising income inequality was partly the consequence of transition-related reforms (e.g. privatisation), but in the WBs it was further aggravated by the particularly difficult economic conditions and isolation of countries that were under international sanctions. Instead of contributing to the achievement of the desired political goals, the sanctions in reality facilitated the enrichment of the privileged political and economic elites (Uvalic, 2010).

Progress with transition-related economic and institutional reforms in the WBs during the 1990s has been variable, though generally slower than in CEEB countries. Initially, Albania, Croatia and Macedonia implemented some reforms at a faster pace than the other countries and were therefore labelled as the "early reformers". The unfavourable political conditions in Bosnia and Herzegovina and FR Yugoslavia postponed more radical economic reforms until later, so they have been labelled as the "late reformers" (see Bartlett, 2008). These initial differences in transition-related economic reforms have become less accentuated after 2001 (see section 3 below).

(3) The WB countries have delayed their transition not only due to their internal political and economic problems, but partly also because of a hostile international environment. During the 1990s, EU policies towards the WB region were different than those applied towards the eight CEEB, or the two South East European (SEE) countries (Bulgaria, Romania). After the outbreak of war in SFR Yugoslavia in 1991, the EU did not elaborate a long-term strategy for the WBs. At that time, for the ten CEEB-SEE countries, it was sufficient to declare the desire to implement the transition to multiparty democracy and market economy in order to be offered substantial financial assistance (PHARE) and preferential trade access through Association Agreements with the EU, which were concluded with the ten countries already during 1993-1996. The WBs, in contrast, were offered similar measures of support of transition and integration with the EU only after the end of the Kosovo war in mid-1999. Moreover, EU conditionality towards the WB countries has become more stringent than it was for the CEEB-SEE countries, consisting of additional conditions[11] and longer procedures, thus postponing in most cases the conclusion of Stabilisation and Association Agreements with the EU.[12]

Therefore, the overall political and economic conditions in the 1990s were fundamentally different in the WBs than in the CEEB region, due to both internal and external factors. The 1990s were a decade marked by extreme political instability which had very profound and long-term economic consequences for all the WB countries. The 1990s had negative consequences for the entire WB region: although Albania and Macedonia were not caught by the military conflicts of the early 1990s, they have also been affected by the region's political instability, as suggested by the limited inflows of FDI or slow integration with the EU. The political tensions from the 1990s have left a heavy burden on most countries' political agendas, including the problems of borders, status, return of refugees, property, minority rights, many of which have still not been resolved.

4. Economic Performance of the Western Balkans in the New Millennium

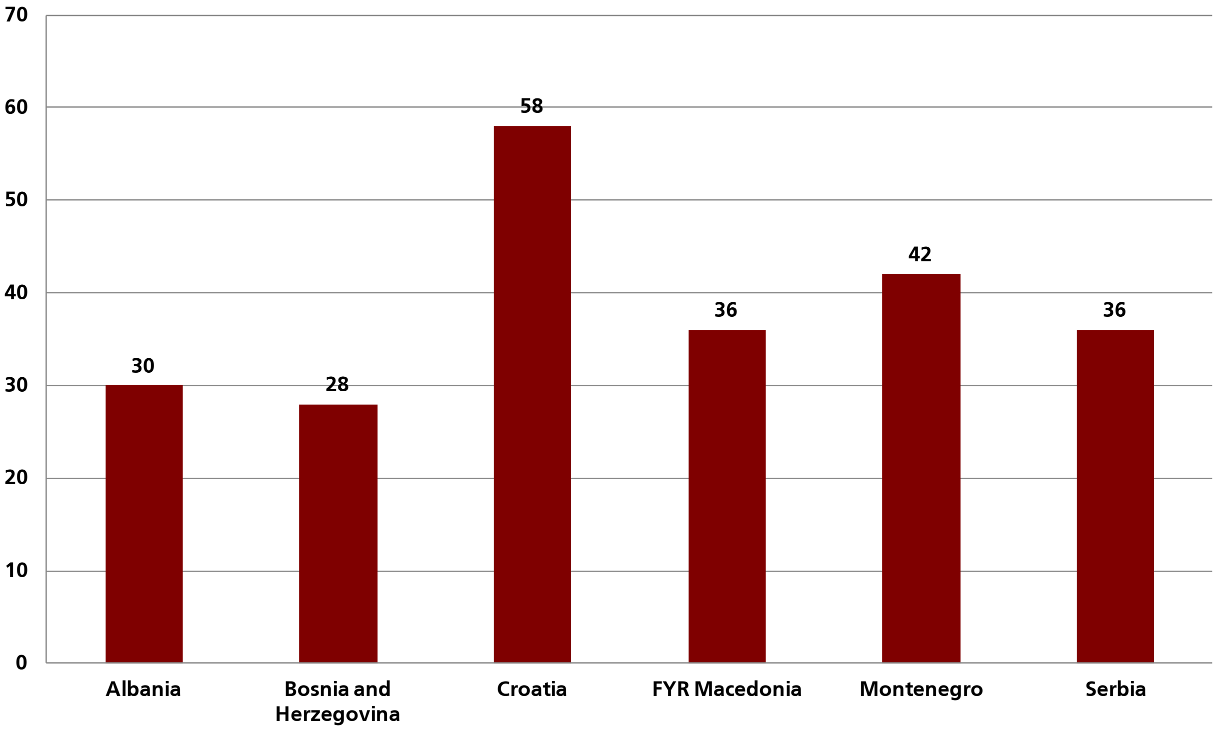
The new millennium brought many positive developments in all WB countries. Generally, in comparison with the previous decade, the WB countries until late 2008 experienced substantial improvements in most macroeconomic indicators. After 2001, many important economic and institutional reforms were also implemented even in countries that were previously lagging behind. Since the early 2000s, the WB countries have registered relatively *rapid economic growth*. During 2004–2008, the WB countries registered high real GDP growth rates, on average for the five-year period ranging from 4 per cent in Croatia to 7 per cent in Montenegro. These high growth rates did facilitate some catching-up with the more developed countries in Europe, but GDP per capita in purchasing power standards (PPS) with respect to the EU average remains low (see figure 1).

Fast growth in the WBs during 2000–2008 was to a large extent sustained by the strong inflow of international finance. A boom in bank credits enabled increased domestic borrowing, as the foreign-owned domestic banks extended an enormous amount of loans to local clients, both firms and households. While government expenditure has also grown, in many countries it has been kept in check by the IMF and the EU (Bartlett and Prica, 2012).

11 In addition to the so-called Copenhagen criteria defined in 1993 for all countries aspiring to join the EU, the WB countries also have to respect international treaties (Dayton Peace Accords, UN Resolution 1244, Ohrid Agreement etc.) and demonstrate willingness to implement regional cooperation.

12 Only Macedonia and Croatia were able to conclude Stabilisation and Association Agreements with the EU fairly early, in 2001. For the other WB countries the conclusion of these agreements was substantially delayed.

Figure 1: GDP per capita in purchasing power standards (PPS) in percentage of EU28, 2015



Source: Eurostat (2017a). Data for Kosovo is not available.

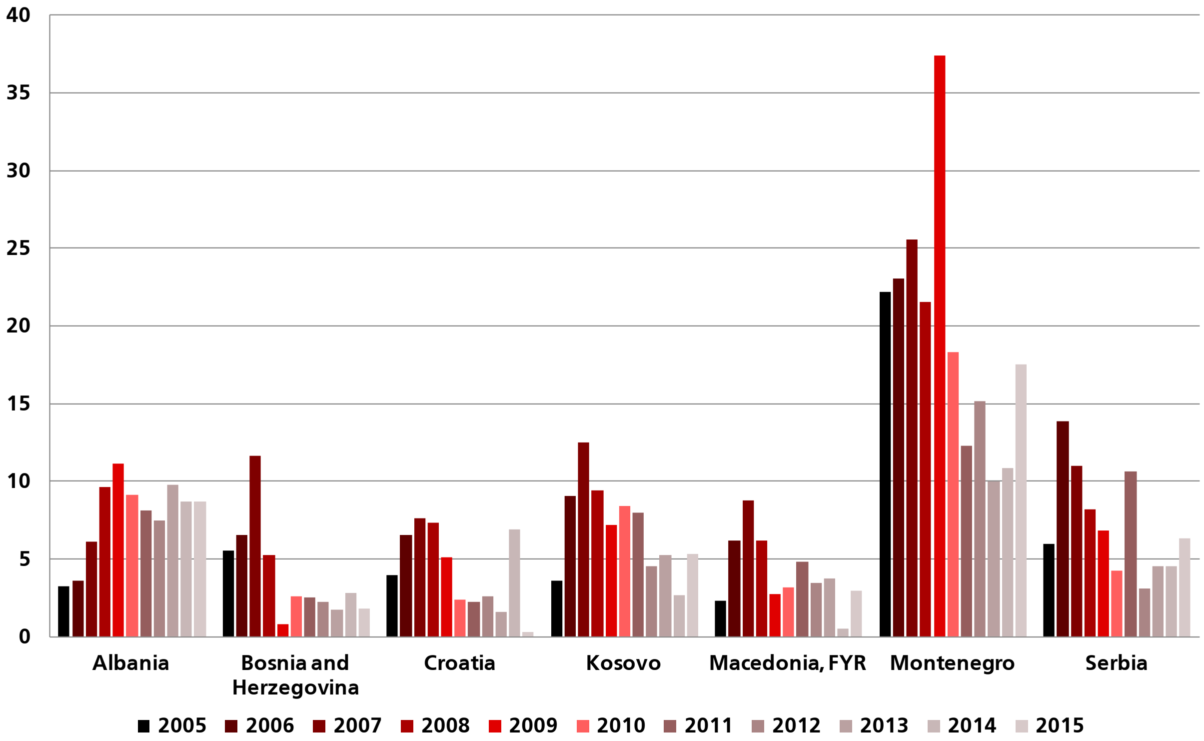
The WB countries have also achieved increasing macroeconomic stability, particularly important after many episodes of hyperinflation in the 1990s. Inflation rates have gradually been reduced to one-digit figures even in countries that earlier experienced extreme monetary instability (e.g. Serbia). Some fiscal consolidation has also taken place through cuts in public expenditure, reforms of the taxation system and stricter fiscal rules, particularly in recent years thanks to EU surveillance through the Economic Reform Programs. The level of public debt as late as 2011 was still below 60 per cent of GDP in all WB countries, thus lower than in a number of EU member states (Bonomi, 2016). Nevertheless, minor changes have taken place in the structure of public expenditure of WB countries, the dominant part still going into pensions and very little into public investment.

The process of *trade liberalisation* after 2001 – with the EU and with the other WB countries (the signing of bilateral free-trade agreements that in 2006 were transformed into the CEFTA-2006 agreement) – has contributed to a remarkable increase in the volume of foreign trade during 2001-08, in some cases by four or five times. Rapid growth spurred an increase in imports which was not accompanied by an equally fast increase in exports, given the relatively uncompetitive WB economies, leading to increasing trade and current account deficits (Bartlett and Prica, 2012). By late 2008, current account deficits reached alarming levels (particularly in Montenegro), being above 10 percent of respective GDPs in all countries except Croatia.

The WB countries have attracted increasing FDI after 2001 (see figure 2), prevalently from EU countries, but also from Russia, Turkey, Norway and Canada. FDI inflows were prompted by the reduced political risk, the massive privatisation of enterprises and banks, relatively low wages and improved prospects of EU accession (Estrin and Uvalic, 2014). However, important disadvantages for foreign investors remain, including the fragmentation of the region, the small size of the WB economies, the lack of economies of scale, and poor infrastructure. The structure of FDI has also not been favourable: until 2010, around 2/3 of FDI has gone into non-tradable services (banking, telecommunications, retail trade, real estate) which serve primarily the domestic market, rather than into manufacturing, so FDI has only marginally contributed to industrial restructuring and to export-led growth (Estrin and Uvalic, 2014). After 2007, most WB countries have registered a decline of FDI by some 40-60 percent, which by 2016 has still not fully recovered to its pre-crisis level.

Since the early 2000s, the WB countries have implemented many *economic and institutional re-*

Figure 2: FDI net inflows in percent of GDP, 2005–2015



Source: World Bank (2017).

forms envisaged by the "ideal" model of a market economy, including price and trade liberalisation, the privatisation of small-scale enterprises and the massive privatisation of state-owned banks. These good results are suggested by the recent transition indicators of the European Bank for Reconstruction and Development (EBRD).[13] Croatia achieved the best results relatively early on, but the other WB countries have caught up in most areas of reform. Today, there are no longer large differences in various areas of economic reforms between the "early" and the "late" reformers, as was the case in 2001. Reforms in the area of price liberalisation, trade and foreign exchange systems and small-scale privatisation have been practically completed in all WB countries. Enterprise privatisation has contributed to the gradual expansion of the private sector, also in countries that were lagging behind (Bosnia and Herzegovina, Montenegro, Serbia), which today accounts for 65–75 percent of the WB countries' GDP.

Still, the private sector in most WB countries remains relatively undersized, which raises doubts about the effective outcome of recent reforms. Privatisation has often not led to improved corporate governance or to deeper enterprise restructuring, since the new owners often lacked the resources and skills to successfully modernise their firms. Competition policy is often ineffective. Many bureaucratic procedures for doing business have been abolished, but with large cross-country differences: in the World Bank's (2017b) update of the Doing Business Report that ranks 190 countries, Macedonia occupies the best position among WB countries (10th), while Bosnia and Herzegovina the worst (81st). The privatisation of the WB countries' banking sector has greatly contributed to strong financial and capital markets integration with the EU, given that the dominant part of the banking sector was bought by foreign (mostly EU) banks. In 2011, foreign ownership (defined as banks with assets in foreign ownership exceeding 50 percent) was still relatively low only in Serbia (74.5 percent), while in all the other countries it was close to or over 90 percent (EBRD Banking Survey).[14] The foreign ownership of banks, though a welcome feature in the initial process of bank restructuring, was also an important channel for contagion by the global financial crisis.

13 The EBRD transition indicators estimate progress in various areas of economic reform in all country members (prevalently countries in transition), on the basis of scores which go from 1 (no or limited reform) to 4+ (comparable to a developed market economy).

14 Foreign ownership of banks (in 2011) was 89,7 % in Montenegro, 90,3 % in Albania, 90,6 % in Croatia, 92,4 % in Macedonia and 94,5 % in Bosnia and Herzegovina (in 2009); see EBRD Banking Survey.

These positive developments in the WBs were sustained by the EU Stabilisation and Association Process (SAP) that offered these countries trade preferences,[15] financial assistance (CARDS, IPA, IPAII), contractual relations through Stabilisation and Association Agreements (SAA) and prospects of EU membership, which was reconfirmed at the 2003 EU–Balkan Summit in Thessaloniki. The new course was also facilitated by political changes in the early 2000s, which brought an end to the one-party domination and authoritarian tendencies in two key WB countries – Croatia (after the death of president Tuđman) and FR Yugoslavia (after the victory of the Democratic Opposition of Serbia over President Milošević in October 2000).

The described positive trends were interrupted by the global financial and economic crisis that severely hit the WB economies from late 2008 onwards. The global economic crisis has generally slowed down economic and institutional reforms in the WBs (though also more generally, in the whole transition region; see EBRD, 2013). The strong effects of the global economic crisis raised the question whether the economic strategy pursued in the WBs had been the best among the feasible policy options.

5. The Effects of the Global Economic Crisis

The global financial and economic crisis hit the WB economies in the last quarter of 2008 through two main channels: (1) reduced inflows of foreign capital, including bank credit, FDI, migrant workers' remittances and donors' assistance (Bartlett and Prica 2012, Bartlett and Uvalic, 2013); and (2) declining demand for WB countries' exports on foreign markets. In addition to reduced capital inflows from abroad, the credit crunch in the EU led to a sharp reduction of credit availability in the local mainly foreign-owned banks. This was almost immediately transmitted to the real sector of the WB countries, causing a sharp contraction in production and aggregate demand. A notable slowdown in economic growth took place in 2009, when most countries registered negative GDP growth, particularly Montenegro (–6%) and Croatia (–6,9%); the only exceptions were Albania and Kosovo that registered a substantial slowdown (see figure 3). In 2009, the positive trends in foreign trade were also reversed, as all countries saw a contraction of both exports and imports.

The WBs were particularly affected by the global economic crisis because of their huge current account deficits, which until 2009 were covered by massive inflows of foreign capital. Moreover, during the 2000s the WBs had become dependent on trade primarily with the EU, but along with increasing trade deficits due to insufficient export growth. The recent privatisation of the WBs banking systems had rendered the WB countries additionally vulnerable, due to the risk of capital withdrawals or reduced credit to local clients under the impact of the economic crisis in their home countries. All three factors continue to be a threat to economic stability in the WBs.

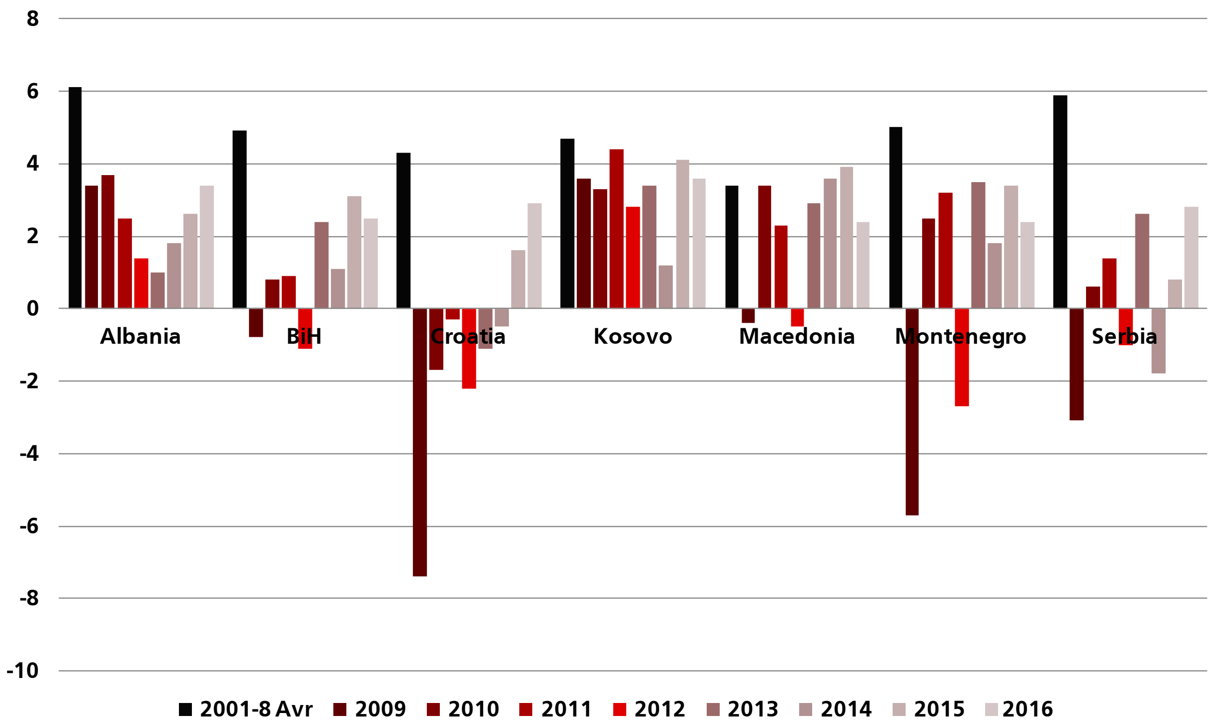
In the immediate aftermath of the global crisis, most WB countries implemented specific economic policies to sustain domestic demand and help the financial sector, which in part helped attain a mild economic recovery in 2010-11. However, the sovereign debt crisis in the eurozone pushed most WB countries into a second recession in 2012 (all except Albania and Kosovo that again registered a strong drop in GDP growth in comparison to 2011). Due to the high degree of euroisation, the WB economies have become highly vulnerable to external shocks coming from the EU/eurozone.[16] After 2012, economic recovery has been very slow, especially in Croatia, which had negative GDP growth rates for six years (only in 2015 did it register positive GDP growth), and in Serbia, which after 2008 had three recessions (in 2009, 2012 and 2014). Although in 2016 all WB countries registered relatively strong GDP growth, of 2–3 per cent, growth rates have still not returned to their pre-2008 levels.

The WBs received external support to help alleviate the severe impact of the global economic crisis, particularly by the IMF and the EU (Bartlett and Prica, 2012). Starting from 2009, the IMF concluded several stand-by arrangements with Bosnia and Herzegovina and Serbia. Even more important has been the so-called "Vienna initiative", a multilateral agreement between the IMF, the EBRD and other banks operating in the region. The agreement ensured that

15 A privileged access to EU markets was offered already in 2000 through EU autonomous trade measures that established a uniform system of trade preferences for all WB countries (FR Yugoslavia was included somewhat later, on 1 Nov. 2000).

16 Though only Montenegro and Kosovo have officially adopted the euro as legal tender, Bosnia and Herzegovina has a currency board which ties its currency to the euro while the other countries have also, officially or unofficially, fixed their currencies to the euro – only Albania has a floating regime; Macedonia has *de facto* fixed its currency to the euro while Croatia and Serbia have a managed float (inflation targeting). Moreover, all WB countries have very little room for implementing effective monetary policy, since a large proportion of domestic liabilities are denominated in euros.

Figure 3: Real GDP growth in the Western Balkans (in %), 2001–2016



Source: IMF (2017a).

host governments would provide deposit insurance and liquidity support for banks, that EU-based partner banks would recapitalise and refinance their subsidiaries in the region, and that home governments would allow bank groups to access home country financial resources without restrictions (Bartlett and Prica, 2012, pp. 28–29). This agreement, designed to prevent foreign-owned banks from pulling out of the region was, in fact, one of the most important factors in stabilising the banking system in the WBs in the early years of the crisis (Barlett and Prica, 2012, pp. 29). The initiative was relaunched in January 2012 ("Vienna 2") in response to renewed risks for the region from the eurozone crisis, but was far less successful, since there was substantial deleveraging by foreign banks as they continued to scale back their exposure in WB countries.

After late 2008, many problems became unsustainable (see sections 5 and 6 below). Although EU policies greatly facilitated economic recovery after 2001, increasing EU – Balkan integration has also rendered the WB economies more vulnerable to external shocks. Increasing integration with the EU has proved to be a double-edged sword: in prosperous times, the European core exported its prosperity towards its southeastern periphery; but in times of crisis, it has exported instability (Bechev, 2012; Uvalic, 2013).

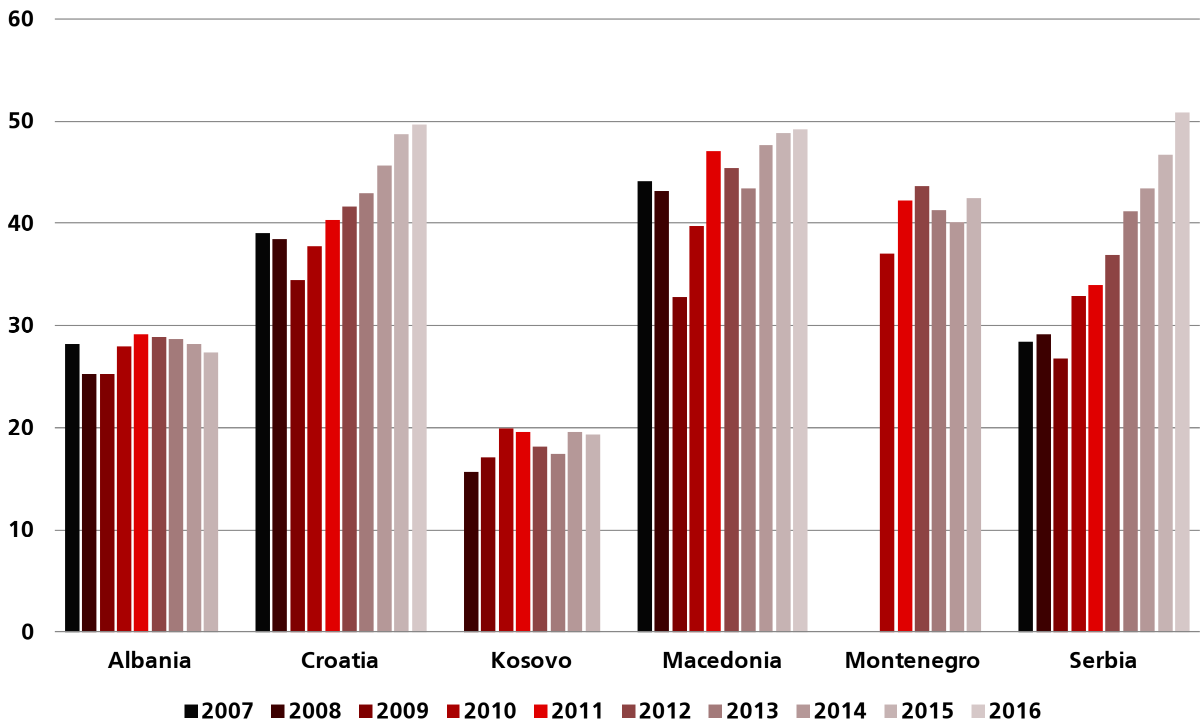
6. Long-term Structural Problems of the WB Economies

The three main groups of structural problems of the WB economies became evident after the outburst of the global economic crisis in late 2008: severe external imbalances; mounting social problems deriving from the unsatisfactory situation on the labour market; and very fast structural changes, characterised by strong deindustrialisation and the very fast expansion, primarily of services. These structural problems have fundamentally contributed to the present low level of economic development of the WB countries.

6.1 External Imbalances

During the 2000s, the WB countries had been facing severe external imbalances. Due to delays in large-scale privatisation, the late arrival and relatively unfavourable structure of FDI, ineffective industrial and competition policies and inadequate changes in the business environment, the process of industrial restructuring of the WB economies has been slow, contributing to insufficient export growth and increasing trade and current account deficits. Limited restructuring of the real sector of

Figure 4: Exports of goods and services in percentage of GDP, 2007–2016



Note: No data is available for Bosnia and Herzegovina.
Source: Eurostat (2017a).

the WB economies, along with policies of strong national currencies, has rendered the WB economies insufficiently competitive on EU/world markets, so their export of goods and services to GDP ratios remain low in comparison with the CEEB countries (Uvalic, 2013) (see figure 4).

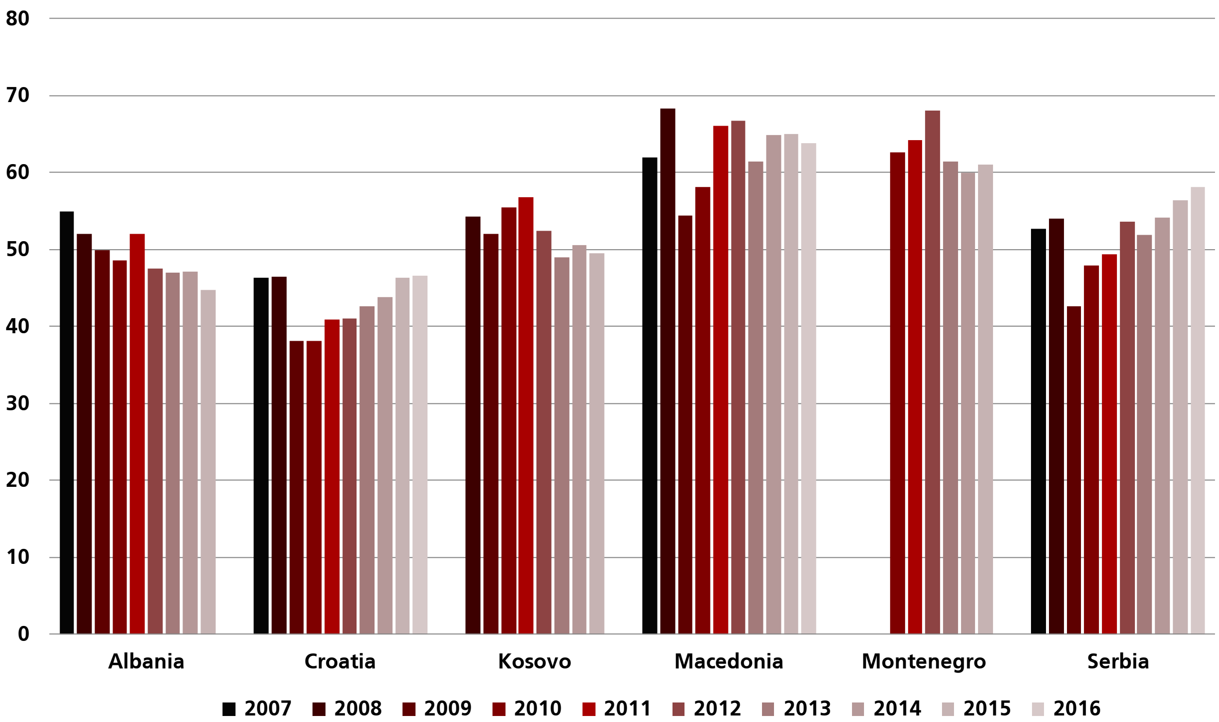
Despite a remarkable increase in WB countries' foreign trade after 2001, exports have often been half the volume of imports, contributing to large trade deficits (see figure 6), which in turn are responsible for the rising current account deficits that in late 2008 were among the highest in the transition region. As indicated earlier, these current account deficits have for years been covered by capital inflows from abroad, which have drastically fallen after 2009.

Although there were some adjustments in the meantime, most countries have had to recur to additional borrowing while some, like Serbia, have also applied a more flexible exchange rate policy allowing some depreciation of the dinar. This has contributed to a rapid increase in external debt, particularly of Montenegro, Serbia and Croatia (see section 6 below). For all these reasons, strengthening external competitiveness through a faster restructuring and technological upgrading of the real sector remains a key priority of all WB countries.

6.2 "Jobless" Growth and Increasing Social Problems

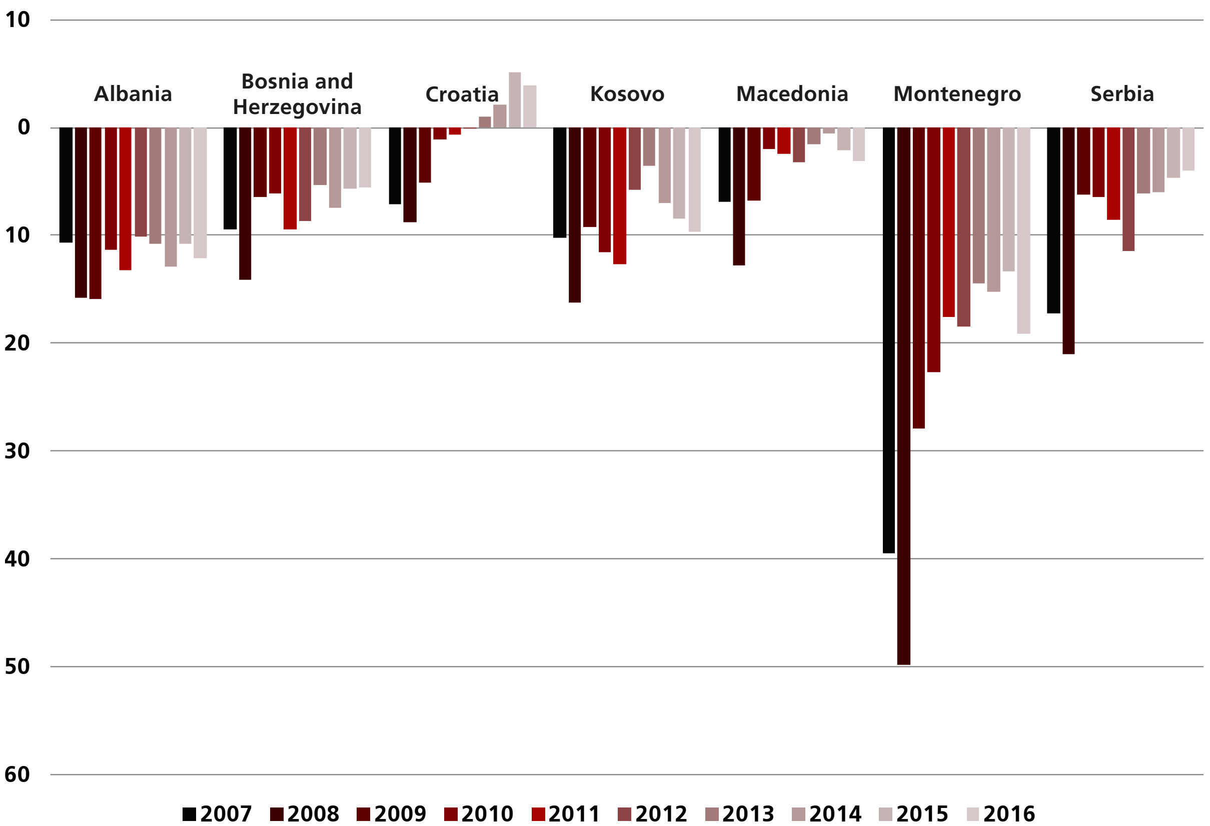
The WB countries have had mounting social problems under the pressure of increasing unemployment, very low employment and participation rates, rising poverty and inequality (Bartlett and Uvalic, 2013). The labour market in the WBs has been characterised by the phenomenon of "jobless growth" and severe long-term structural problems. The restructuring process led to the closure of many firms and loss of jobs, but economic growth was not accompanied by an equally dynamic process of job creation. Although the CEEB countries have also faced similar problems in the 1990s, the extent of these problems in the WBs has been much more pronounced. In recent years, the WBs have been the countries that have registered among the highest unemployment rates (see figure 7) in Europe. Long-term and youth unemployment rates have also reached alarming proportions. In 2015, the average unemployment rate of graduates with a higher education diploma in the WBs (without Croatia) was 15,6 percent, therefore three times higher than the average of the EU28 (5,5 percent) (Bartlett et al, 2016). With such high unemployment rates, it is clear that economic growth in the WBs remains below their potential. Recent employment rates of the

Figure 5: Imports of goods and services in percentage of GDP, 2007–2016



Note: No data is available for Bosnia and Herzegovina.
Source: Eurostat (2017a).

Figure 6: Current account balance, 2007–2016 (in % of GDP)



Source: IMF (2017a).

WB countries have also been extremely low, well below 50 percent, at a time when in the EU the objective is to reach a 75 percent employment rate by 2020 (see figure 8).

The WB countries also face a worsening of their social climate, under the impact of further increases in poverty and inequality (Bartlett and Uvalic, 2013). A substantial part of the workforce still works in the more flexible informal sector, preventing the collection of badly needed public revenues. According to some estimates, the level of informal activity, measured as a share of household income, is highest in Albania (52 percent), Kosovo (45 percent) and Macedonia (39 percent), while the Bosnian Federation, Serbia and Croatia have lower levels of around 18-19 percent (Bartlett, 2008, p. 125). Income inequality has been substantial: Gini coefficients range from 26,2 in Montenegro, 30,4 in Croatia, 33,4 in Bosnia and Herzegovina and 33,7 in Macedonia to an extremely high 38,2 in Serbia – therefore in three of the five countries higher than the EU28 's average of 31 (Eurostat, 2017a; European Commission, 2016a, 2016e). A report on social protection and social inclusion in Albania, Bosnia and Herzegovina, Kosovo, Montenegro and Serbia claims that the major drivers of social exclusion and inequalities lie in labour markets and educational systems; in addition, public insurance-based pension systems are under strain due to negative demographic trends, early retirement practices as well as the labour market situation (Stubbs, 2009, p. 15, 70). However, social protection benefits in percentage of GDP were lower in the WB than in the EU28 in 2012, for the countries for which data are available (Eurostat, 2017, 2017a). In sum, negative social trends and weak social safety nets mean that the WBs face considerable obstacles for socioeconomic development.

6.3 Structural Changes

All transition countries have experienced radical structural changes during the past quarter of a century: a notable decline in the share of agricultural value added; deindustrialisation with falling absolute employment and output in all branches of industry, particularly manufacturing and energy; and a substantial expansion of the services sector, which remained underdeveloped during socialism. However, the WB countries have gone through an extreme process of deindustrialisation, since industrial decline typically occurred not only in the early 1990s (as in other East European countries), but continued in most WB countries in the 2000s as well. The share of tradable goods, dominated by manufacturing, has declined significantly, further aggravating the problem of insufficient export growth and low competitiveness. Structural changes in the WB have resulted in an oversized services sector and the premature reduction of manufacturing, to levels inconsistent with these countries' levels of economic development. By 2013, the share of manufacturing value added in the seven WB countries was only 12 per cent of GDP (unweighted average), therefore lower than in many EU countries, particularly the new member states – the Czech Republic, Slovenia, Hungary and Slovakia, where it ranged from 20–25 percent (see figure 9). The structure of foreign investment has greatly contributed to such patterns of structural change, since most FDI has gone into non-tradable services (Estrin and Uvalic, 2014).

Mencinger (2003) recalls the important difference between greenfield and privatisations-related FDI: while a strong link between greenfield FDI and capital formation is self-evident, acquisitions by foreign partners cannot be automatically considered as investment in real assets. Proceeds from privatisation sales might be spent on current consumption and imports, in which case FDI would not directly contribute to the growth of productive capacities and to economic growth, but to an increasing current account deficit developing into foreign debt. Though Mencinger's arguments are based on the experience of the more advanced CEE countries in the 1990s,[17] they are very relevant for the WB countries (Uvalic, 2010, p. 188).

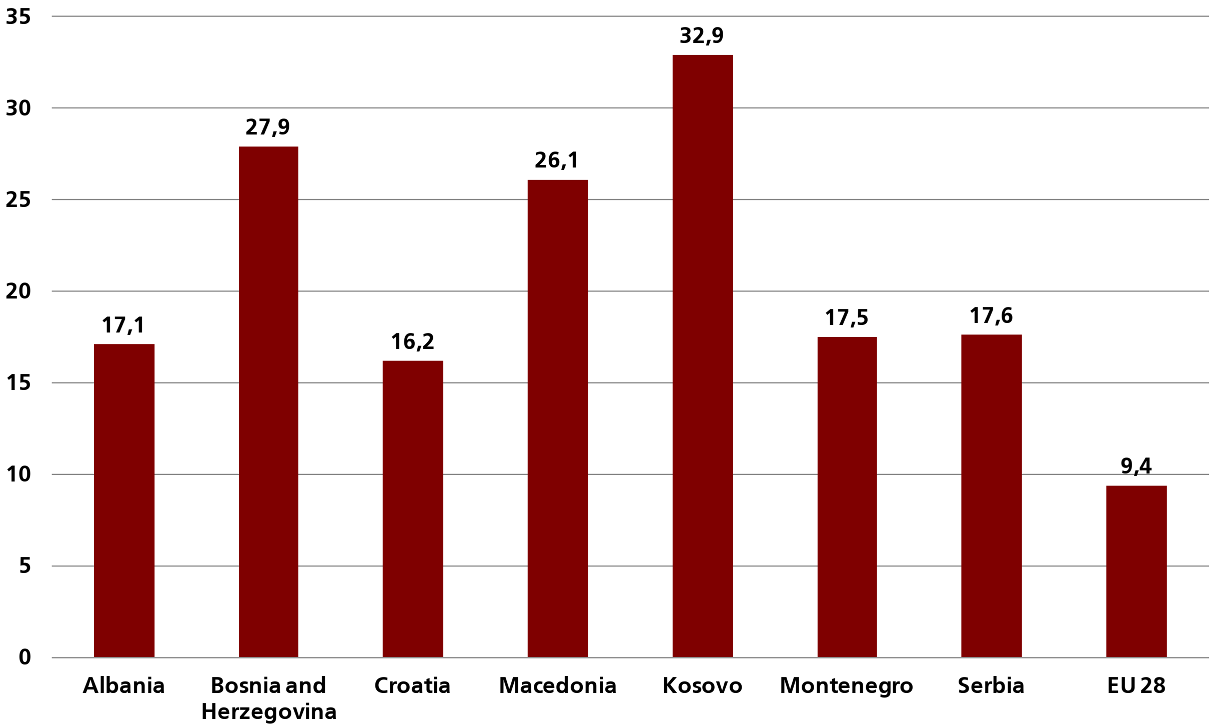
Still, industrial changes have resulted in less polluting production per unit of GDP in all countries except Bosnia and Herzegovina. Data for the past several years, available for only some countries from the OECD (Green Growth, 2017), shows that CO2 emissions per capita fell in Serbia, Macedonia and Albania, slightly grew in Croatia and Montenegro and steeply grew only in Bosnia and Herzegovina. However, while carbon productivity (GDP per kilogram of CO2 emissions) somewhat fell in the latter, it grew in all aforementioned countries for which data is available.

The share of industry[18] value added in GDP sharply fell in Eastern Europe after 1990, a normal

17 Mencinger's regressions suggest a negative impact of FDI on economic growth in eight CEE countries. The results are explained by the fact that FDIs were predominantly acquisitions related to massive and often politically motivated privatisation, while proceeds from sales were spent on consumption and imports (Mencinger, 2003, p. 504).

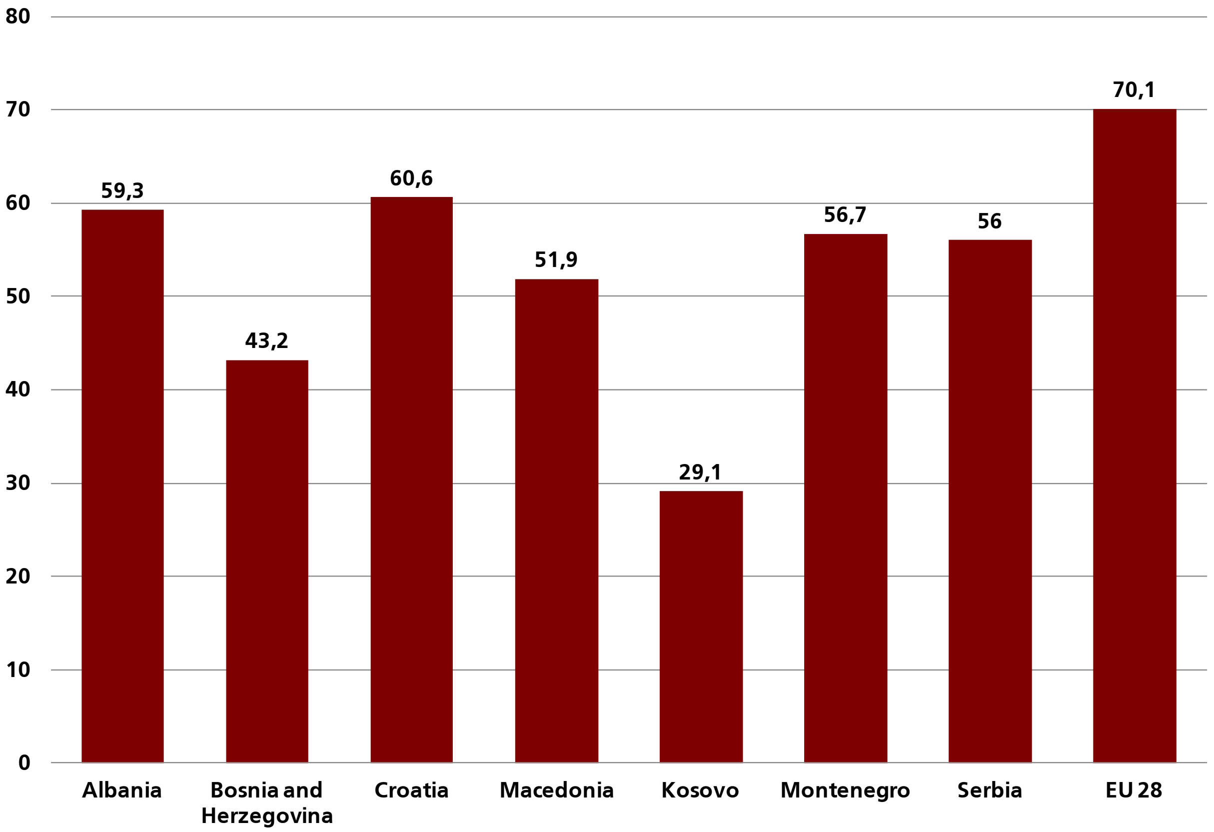
18 Industry corresponds to ISIC divisions 10–45; it comprises value added in mining, manufacturing (ISIC divisions 15–37), construction, electricity, water, and gas (World Bank, 2017).

Figure 7: Unemployment rate, 2015



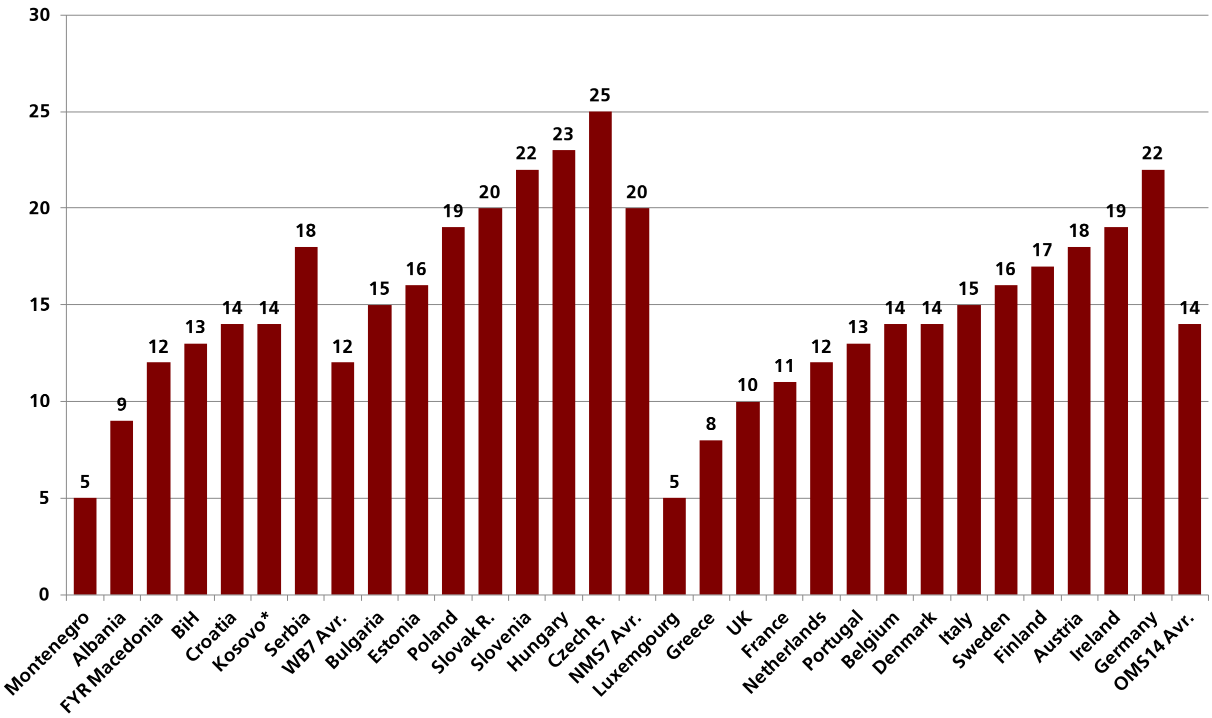
Source: Eurostat (2017a): codes cpc_pslm, lfsa_urgan.

Figure 8: Employment rate, 2015



Source: Eurostat (2017a): codes lfsi_emp_a and cpc_pslm.

Figure 9: Manufacturing value-added (in percent of GDP), 2013



Note: Countries not included are those for which 2013 data were not available (Latvia, Lithuania, Romania, Cyprus, Malta, Spain).
Source: Compiled on the basis of World Bank (2017).

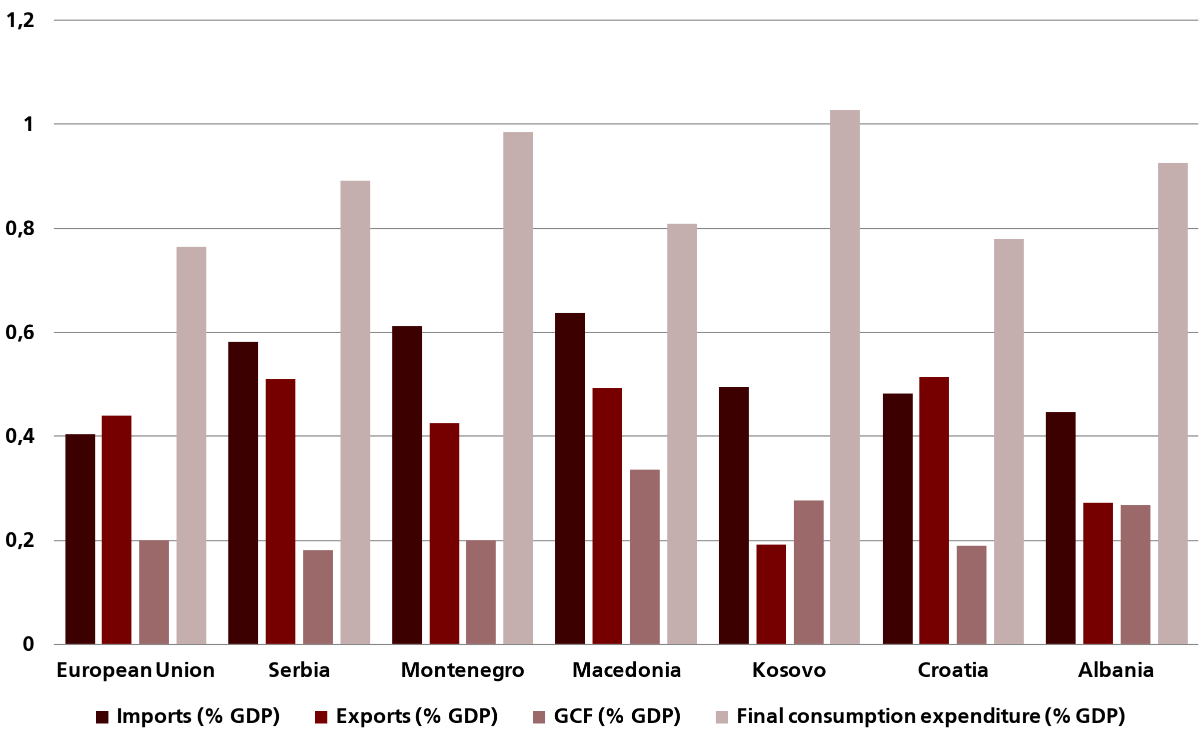
consequence of an oversized industrial sector during socialism. The scale of the decline was much greater than in the EU. In the EU during 1991–2015 this decrease was on average 21,32 %, while in Albania and in Macedonia it was 40,45 % and 26,56 %, respectively. Unfortunately, the lack of comparable data does not allow us to show what was probably an even more drastic decline in the share of industry in Bosnia and Herzegovina, Croatia and FR Yugoslavia (Serbia and Montenegro).. Furthermore, the share of manufacturing value added in GDP in 2015 in all the WB countries but Serbia (in 2013), was generally lower than in the EU (World Bank, 2017, see also Figure 9).

These are some of the structural problems that have hampered the process of *economic recovery and catching up* of the WBs with the more developed countries. Since the early 2000s, some catching up has taken place with respect to the EU average GDP per capita, thanks primarily to higher growth rates in the WB countries (but also because of a slight lowering of the EU average after the EU 2004–07 enlargement). Nevertheless, strong growth in the WB countries during 2001–08 has not been sufficient to compensate for the very substantial output fall in the 1990s. Only Albania, Croatia, and Macedonia have surpassed their 1989 real GDP level (the latter two fairly recently), while in 2008 Montenegro was still at 92 percent, Bosnia and Herzegovina at 84 percent, and Serbia at 72 percent of real GDP produced in 1989 (Uvalic, 2010). After the recent recessions, most countries have experienced a further setback: by 2012 Croatia was again under the level of its 1989 real GDP, while Serbia was at 70 percent. There has been little convergence in incomes with the more developed EU: with the exception of Croatia, GDP per head remains low.

7. The Current Economic Situation in the WBs: Specific Policy Constraints

The WBs today also face a number of challenges due to specific constraints on their economic policies. Regarding macroeconomic policy, the WB countries share a rigid monetary policy coupled with generally restrained fiscal policy. As Kosovo and Montenegro use the euro as their domestic currency, Bosnia and Herzegovina has a currency board, while Macedonia and Croatia have more or less fixed their exchange rate, all these countries effectively cannot use monetary policy in order to boost their economy. Albania is an exception, as it has maintained a flexible exchange rate. Serbia has combined a flexible exchange rate policy with high interest rates (the latter case described by Becker,

Figure 10: Structure of GDP



Note: Data for Croatia, Macedonia, Serbia and the EU refer to 2016. The rest of the data refers to 2015, except for the data on GCF in Albania (2014 was the last covered year). There is no data for Bosnia and Herzegovina in the cited source. Source: Eurostat (2017a).

2012), though they have lately fallen. In addition, all WB countries have a high degree of euroisation of their economies, which seriously hampers the effectiveness of monetary policy instruments.

As regards to fiscal policy, austerity policies have generally been implemented in recent years throughout the region, except in Kosovo and Albania (see Bartlett and Uvalic, 2013; Bonomi, 2016). However, there is room for a different type of fiscal policy in most countries, as their general government consolidated gross debt (i. e. public debt) relative to GDP is lower than the EU28 average in all countries except Croatia (being an EU member state, it needs to respect the Stability and Growth Pact's limit of 60 percent). In fact, in Bosnia and Herzegovina, Macedonia and Kosovo public debt is still much lower than 60 percent of their respective GDPs (Bonomi, 2016; for data see Eurostat, 2017a). Serbia has recently "overperformed" in fiscal policy consolidation: in 2016 the general government deficit dropped to 1,4 percent of GDP (the lowest since 2005), contributing to a reduction in government debt to 74 percent of GDP (see IMF, 2017). Yet the European Union is in favour of further fiscal consolidation in all the WB countries, which remains substantially under its control (see Cvijanović, 2017). It should also be stressed that difficult policy measures are rather restrained in situations of generally, weak, social dialogue (see European Commission, 2016, 2016a, 2016b, 2016c, 2016d, 2016e) that makes it harder for social partners to agree on a policy direction.

Although the pace of GDP growth gradually picked up in the 2000s, this was due to a model of economic development that until 2008 relied heavily on an excessive increase in credit, fuelled by increasing foreign capital inflows. Becker and Ćetković (2015) found that financialisation[19] was the main factor behind GDP growth in the pre-crisis period in Bosnia and Herzegovina, Croatia, Serbia and Montenegro, characterised by the rapid growth of banking credits driven by foreign-owned banks. Hence, the financial sector grew in scale and importance, driving GDP growth until the outbreak of the crisis. Thereafter, GDP growth rates slowed down substantially.

The structure of GDP is unfavourably skewed towards domestic consumption (see figure 10) which may remain subdued due to the budgetary pressures on both households and the general government. Furthermore, all countries but Croatia have negative net exports (of goods and services). Hence, the attention of policy makers should turn

19 Financialisation can succinctly be defined as growth in size and importance of the financial sector.

to major investments, which have generally seen a downward trend after the crisis (see figure 11). As to the financing of investment, all countries except Croatia and Macedonia have much lower savings rates than the average in the EU (see figure 12).

Regarding exports and employment, for the Visegrád countries and Slovenia, what was particularly important were FDI inflows into complex industries. This is precisely where the WB countries failed. As their institutional structures grew more similar, their production structures developed in a different direction and could not catch up with the more advanced economies of the post-socialist world (Bohle and Greskovits, 2012). Recent empirical evidence suggests that FDI in the WBs has not only not had any positive spillover effects on manufacturing value-added, employment and exports, but has even had negative effects, as for example on employment in the textile industry (see Estrin and Uvalic, 2016).

8. Long-term Policy Failures and Future Priorities

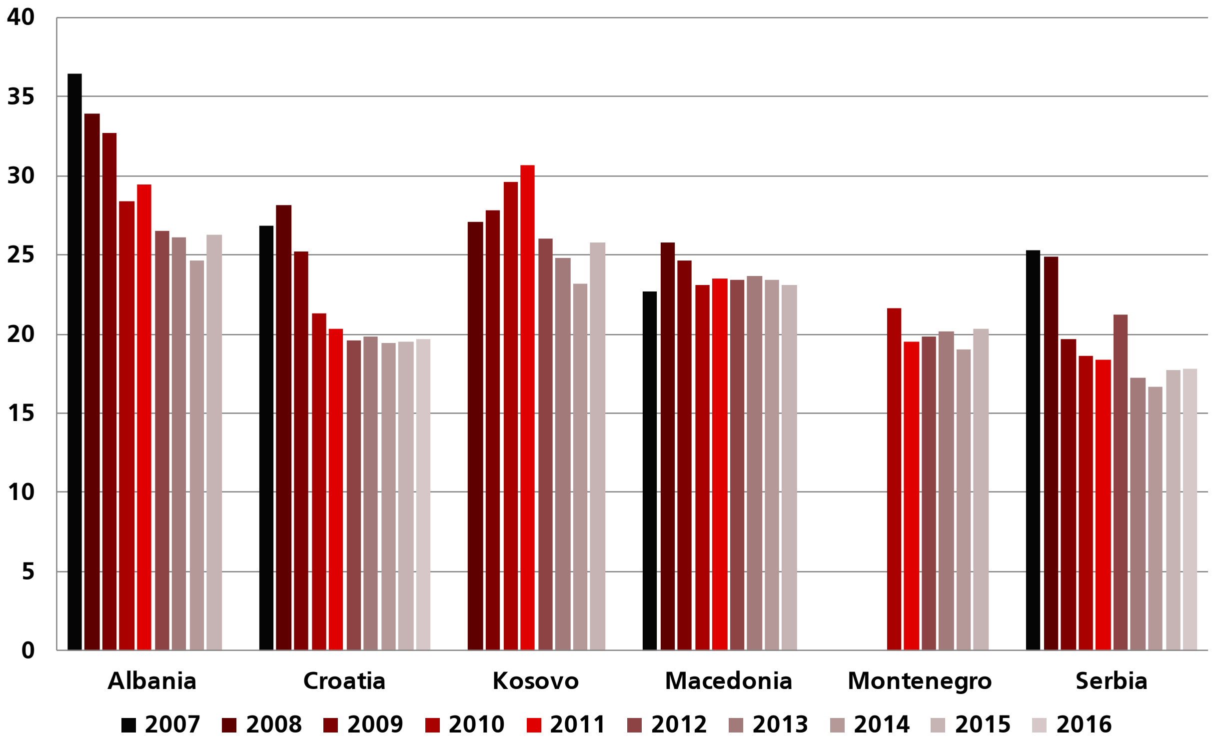
There are further reasons why economic development in the WB countries has produced suboptimal outcomes, deriving from more general long-term policy failures: (1) political/constitutional problems; (2) transition and growth strategies; and (3) inappropriate regulatory, institutional and legal frameworks.

(1) *Political/constitutional problems.* Two countries have major problems of a constitutional nature – Bosnia and Herzegovina and Kosovo. While the former has a complicated two-tier structure comprising the Federation and Republika Srpska that produces constant nationalistic tensions, thus preventing the effective implementation of a model of development for the country as a whole, the latter still has substantial institutional problems and has not even been recognised by all EU member states since its unilateral proclamation of political independence in February 2008. Furthermore, Macedonia has been halted in its EU integration process due to Greek demands regarding its name, while the tensions and sporadic violent clashes between ethnic Macedonians and ethnic Albanians have made it difficult for the country to focus on developmental priorities. Croatia, first affected by the war (1991–1995), had a late start in important transition-related reforms, so some of its public policies are still tied to interest groups directly connected to the war. Serbia and Montenegro have not been very different in this sense, as sanctions against FR Yugoslavia in the 1990s and later the NATO air strikes led to a substantial regression in all socio-economic indicators. In 2006, the separation of Montenegro from FR Yugoslavia (Serbia) meant that both countries had to deal with major political challenges, while the situation in Serbia after 2008 has been additionally complicated by Kosovo's declaration of independence. In contrast, Albania has had a much smoother transition path, uninterrupted by major political events (aside from the pyramid schemes crisis in 1997 ending with an abrupt fall in GDP and mass protests). However, it started from an institutional and economic development level which was much lower than in the other WB countries.

(2) *Transition and growth strategies.* The growth strategy based on fast trade and financial opening, rapid credit expansion and increasing dependence on foreign capital has been much less successful in the WBs than in CEEB (Uvalic, 2012). The transition in the WB region, similarly to that in CEEB, was prevalently based on the prescriptions of orthodox mainstream economics, or the "Washington consensus", which placed strong emphasis on liberalisation, macroeconomic stabilisation and privatisation. Other important areas of reform, particularly at the microeconomic level, were neglected – such as improving the business environment, firm restructuring or competition policy. Although the "post-Washington consensus" developed in the second half of the 1990s had suggested the high costs, in terms of slower growth, of excessively restrictive macroeconomic policies (Kolodko and Nuti 1997, p. 49–52), in the WBs this was not taken into account.

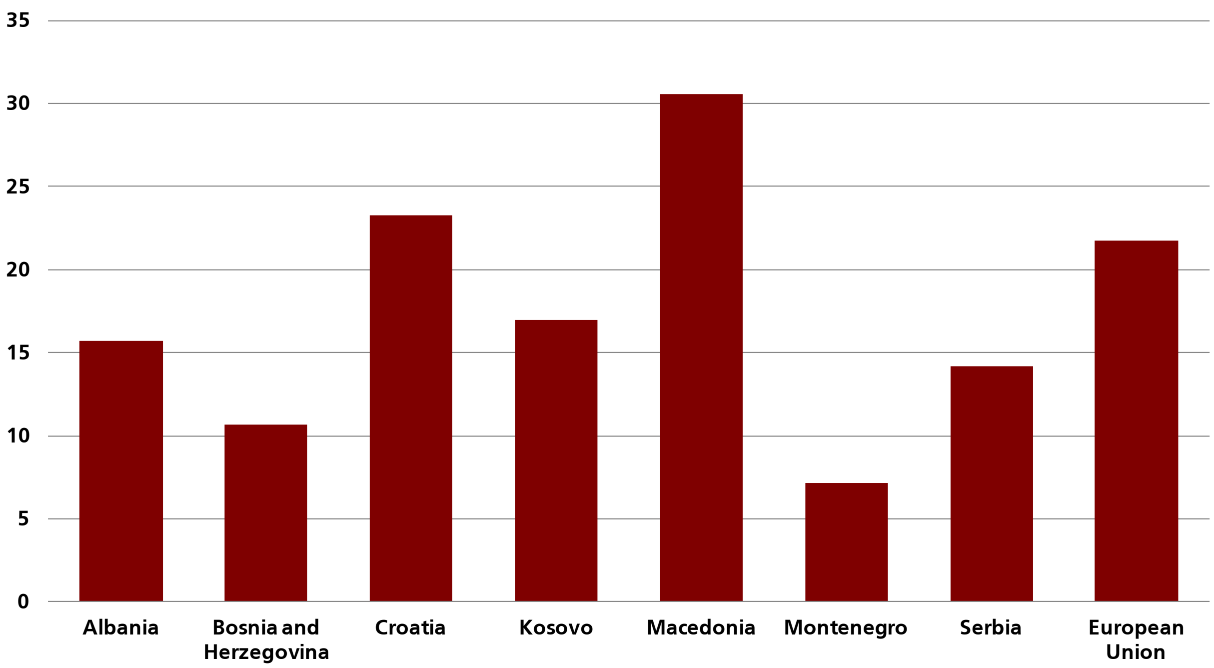
In particular, the neoliberal policies implemented in the early 1990s in Albania and Macedonia, backed by the IMF-supported shock therapy programs, included substantial cuts in government expenditure that reduced the role of the state to a bare minimum, which had adverse consequences for sectors such as education and health. In Bosnia and Herzegovina or Kosovo the neoliberal policies brought even more disappointing results, a stable currency being probably the only important exception (Uvalic, 2012). The economic recovery of these war-devastated and highly deindustrialised economies has been very slow, institution-building has taken much longer than expected, and many solutions imposed externally by international donors have not been appropriate. In Serbia, capacity restructuring was expected to take place almost entirely through privatisation, a process which has proceeded very slowly and has not been accompanied by other important measures, such as improving the regulatory environment for enterprise entry and exit, or increasing competition through effective anti-trust policy (Uvalic 2010). Croatia has

Figure 11: Gross fixed capital formation[20] (in percentage of GDP), 2007–2016



Note: There is no data for Bosnia and Herzegovina. We use gross fixed capital formation (GFCF) instead of gross capital formation (GCF) since there is more detailed data on the former than the latter.

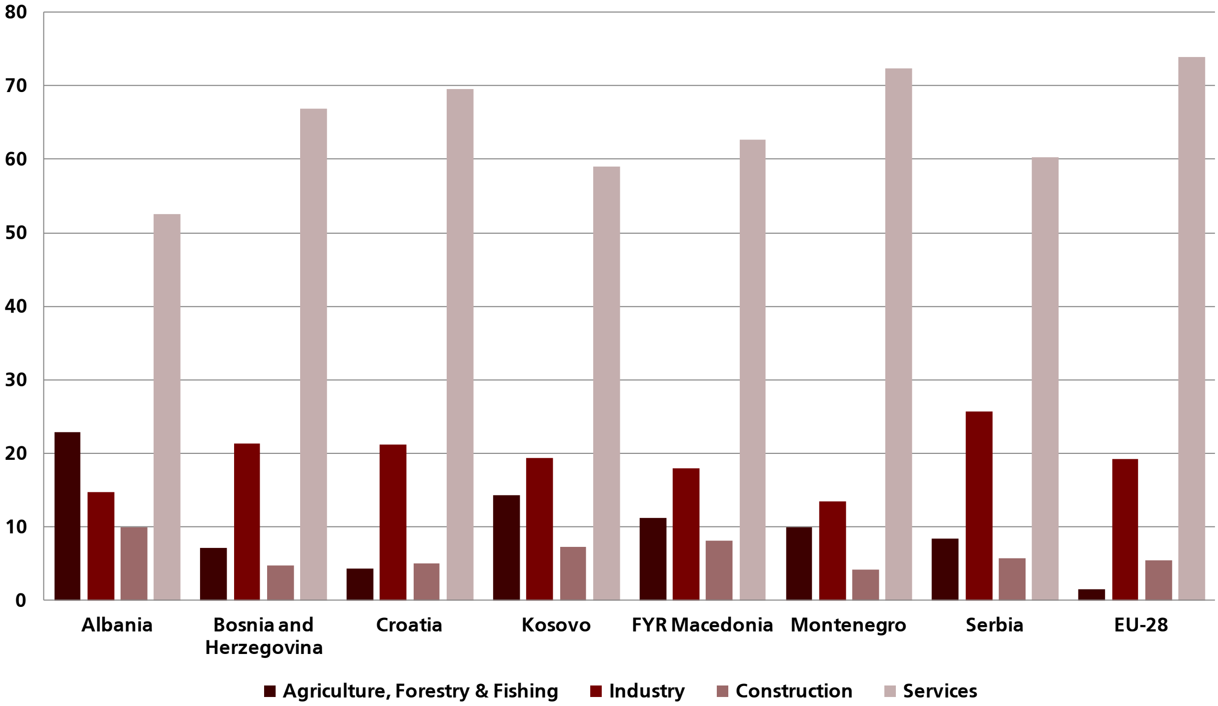
Figure 12: Gross savings in percentage of GDP, 2015



Note: Data refer to 2015, except for Bosnia and Herzegovina for which the last available data were taken, for 2014.
Source: Own calculations based on data of World Bank (2017).

20 Gross fixed capital formation "consists of resident producers' investments, deducting disposals, in fixed assets during a given period. It also includes certain additions to the value of non-produced assets realised by producers or institutional units. Fixed assets are tangible or intangible assets produced as outputs from production processes that are used repeatedly, or continuously, for more than one year" (Eurostat, 2017a).

Figure 13: Gross value added by sectors, 2014–2015



Note: Data for Albania, Bosnia and Herzegovina, Kosovo and Montenegro are for 2014, for the other countries they are for 2015.
Source: Eurostat (2017a) and European Commission (2016a), pp. 78–79.

achieved faster progress with regard to many transition objectives and is the most developed Balkan country, yet it also has a number of reforms to complete, its recent growth has been based on heavy borrowing from abroad making it the most indebted Balkan country, and it has been among the most severely hit by the global economic crisis.

(3) *Institutional, regulatory and legal frameworks*. The failure to establish appropriate institutional, regulatory and legal frameworks has impeded the supply response necessary for reducing unemployment and generating sustained economic development (Daviddi and Uvalic, 2006; Uvalic, 2012). As a result of neoliberal policies that reduced the role of the state to the bare minimum, the WB countries have failed to develop active government policies in many important areas. They have mainly implemented a horizontal-type industrial policy (Bartlett, 2014), which has only marginally contributed to the process of industrial restructuring. Recent institutional, economic and political indicators highlight a substantial gap between the WB and CEEB countries, including indicators on technological readiness and rule of law (Estrin and Uvalic, 2016).

In future strategies of economic development, there are four areas that need to be considered by all WB countries, as they seem to be common priorities: agriculture, energy/environment, investment in R&D (human capital) and public administration reform.

(1) *Agriculture* has so far not been given the right attention, although it still contributes a very high share of gross value added in all the WB countries (see figure 13), much higher than the EU average. The importance of agriculture for employment, exports, food sovereignty and fight against climate change has traditionally been neglected. During the 2005–15 period, Albania, Bosnia and Herzegovina, Kosovo, Macedonia and Montenegro had trade deficits in food, live animals, drinks and tobacco, partly due to an early and exceptionally fast liberalisation of imports from the EU, while only Serbia had a surplus (see Eurostat, 2017a). Croatia has had a huge trade deficit in agricultural trade in recent years (European Commission, 2017), despite having a rather developed food industry. Znaor and Landau (2014) find that a switch to organic farming in Bosnia and Herzegovina, Croatia, Montenegro and Serbia would result in an increase of 100.000 jobs, provide higher gross value added and have beneficial ecological effects.

(2) *Energy* is another important sector, though the situation in the WB countries is very heterogeneous. There are wide differences regarding total primary energy supply, the energy mix, the volume of national energy production and dependence on imported energy. Most WB countries are not able to cover their essential energy needs through domestic production, but import from other countries. The size of the WB countries' markets, in

terms of final energy consumption, varies, but most of the markets are very small (Uvalic, 2014). Most WB countries are not just dependent on imports, but produce energy in a highly polluting way, while their power plants are in need of investment. Yet renewable energy sources have been mostly neglected. The recent increase in EBRD's financing of the green economy by 85 percent so far in 2017 opens excellent opportunities for the WB countries to raise funding for developing renewable energy sources. The EBRD's Green Economy Transition (GET) approach aims to dedicate 40 percent of its annual investments to climate finance by 2020, compared with an average of around 25 per cent in the previous five years.

(3) *Investment in human capital* should also be a priority in all WB countries, since expenditure for education, R&D and innovation is generally low. Sectors of innovation and research have faced serious underinvestment not only in the 1990s but also more recently. The WBs have failed to develop systems and institutions that would support modern innovation policies. Among WB countries ranked in the European Innovation Scoreboard, Macedonia is at the bottom end with "modest innovators", while Croatia and Serbia are among "moderate innovators" (the latter being ranked higher than the former). Innovation promoting strategies must become part of a wider policy framework that would include other areas of reform, including education, the development of skills of young people through vocational training, more opportunities for internships and introducing closer cooperation between higher education institutions and the business sector (Bartlett et al., 2016).

(4) *Public administration reform* must come on top of the policy agenda of all WB countries, since giving priority to the above areas will not be sufficient without a more efficient public administration. This is suggested by the Worldwide Governance Indicators (see World Bank, 2017a).[21] Although Croatia is situated at the bottom among EU member states, it fares better than all WB countries except for the indicator on "regulatory quality", in which Macedonia is slightly better. The WBs have weak administrative capacities which cannot adequately respond to the increasing demands of the EU to develop modern, forward-looking public policies. Other indicators confirm the poor quality of the WBs public administration (e.g. the Economist Intelligence Unit Democracy Index).

21 The Worldwide Governance Indicators measure six areas: 1) voice and accountability, 2) political stability and absence of violence/terrorism, 3) government effectiveness, 4) regulatory quality, 5) rule of law, and 6) control of corruption.

9. Conclusions and Policy Recommendations

After a prolonged and difficult transition path, the WB countries still do not seem to be on a development path that would guarantee future socio-economic prosperity. Key long-term structural problems of the WB economies – limited competitiveness on world markets, "jobless" growth, increasing social problems, extreme deindustrialisation – have not been resolved, while growth based on excessive credit expansion has come to an end. Although the macroeconomic situation has recently improved, GDP growth rates are still subdued in comparison to the pre-crisis period, while fiscal and monetary policies have limited room of manoeuvre. Current economic and social problems are a serious constraint for the future development of the WB economies. Rather than just strive for increased economic growth, the WB countries should aim at implementing *a more balanced model of development* that would take into account social, economic and ecological aspects. High inequality, unemployment and poverty ask for redistributive policies that would combat mounting social problems and secure decent living standards. The WB countries should enable its population to enjoy decent work and pursue the goal of social inclusion, envisioning a just transition to an economy that is also environmentally sustainable (see ILO, 2015, p. 4).

In order to pursue these goals, WB policy-makers need to elaborate and implement *a more efficient industrial policy*. Such industrial policies need to be country-specific, carefully prepared in each country on the basis of national priorities. Governments need to influence the quality of investment – both foreign and domestic – particularly its sectoral distribution. In order to diversify and upgrade the production and export base, policy makers should not wait to see what international market forces bring to them; recent findings by Harding and Javorcik (2012) show that sector targeting by investment promotion agencies – not simply opening the host economy to FDI – doubles FDI flows into the chosen sectors and results in higher unit-value exports (Moran, 2014, p. 32). The WB governments also need to devise such mechanisms for selecting industries and providing packages of public sector support to address coordination externalities, overcome imperfections in information markets, while providing investors with public goods, such as a well-trained labour force. Such an approach is what Moran calls "light-form industrial policy" that could harness FDI to development and generate backward linkages as deep as possible into the host economy (Moran, 2014, pp.

32–33). The potential benefits of FDI for the host economy depend, among other things, on national infrastructure, market size, systems of education and training, institution quality, political stability and the control of corruption (Estrin and Uvalic, 2016).

Investment promotion policies directed towards potential foreign and domestic investors need to be linked to the *most important objectives of national economic development*. After more than eight years of economic crisis and feeble economic recovery, it seems risky for the WB governments to merely wait for the return of foreign investors and to continue relying on their capabilities to restructure their economies. An investment promotion strategy needs to aim at attracting not only more, but also better quality, investments that would facilitate a faster restructuring and technological upgrading of key industries. Such an investment policy should also influence the sectoral distribution of domestic and foreign investments, that should extend across sectors of agriculture, energy, R&D, education and innovation. More efficient policies promoting organic farming and those connecting the agricultural sector with food industry should be implemented. The WB countries should reduce their dependence on highly polluting energy production (coal) and increase their energy sovereignty by reverting to renewable energy sources. FDI can be a welcome supplement to the still low domestic savings characterising all WB countries, but it is unlikely to be sufficient to secure faster and sustained economic development. As elsewhere, FDI is influenced not only by government policies, such as institutional reforms and tax incentives, but by exogenous factors such as size, level of development and geographical position (Estrin and Uvalic, 2014). The economic smallness and fragmentation of the WB region implies the lack of economies of scale, which remains a serious handicap for these countries.

One way to overcome this handicap and accelerate WB economic development is through *more intensive regional cooperation*.[22] The current institutional crisis of the EU and the related bleak prospects of a quick accession of the current candidates and potential candidates implies that they ought to devise new mechanisms to accelerate economic development in order to prepare for the future competitive pressure within the EU. Coordinating national policies in some of the priority areas in order to implement regional initiatives jointly makes a lot of sense for small economies such as the WBs, particularly considering the legacies and economic linkages inherited from the former Yugoslavia. Although the benefits of regional cooperation have been emphasised for long (Uvalic, 2001), its potentials have not been sufficiently utilised. More intensive regional cooperation in the area of R&D, energy, transport, agriculture or specific industries has the potential of accelerating growth in the WBs in the medium term. Industrial policy at the regional level through the creation of trans-national networks and supply chains could be mutually beneficial, since multinational companies created by enterprises from several WB countries are bound to be more competitive on EU markets than small national firms. The SEE 2020 Strategy adopted by the Regional Cooperation Council and the ministers of the respective SEE countries in Sarajevo in November 2013 is an attempt to implement the desired regional cooperation initiatives. The Berlin process also represents a step forward in this regard. Whereas recently there has been some progress in initiating a Regional Economic Area in the WBs (see European Commission, 2017a), a lot more could be done in most areas of regional economic and political cooperation.

Regarding the *role of the EU*, the renewed EU enlargement policy based on three pillars – Public administration, Rule of Law and Economic governance – now grants major importance to problems of economic development. This is promising, since in the past, and for too long, economic problems were in the shadow of political issues. In particular, the new policy instrument recently introduced by the European Commission – the Economic Reform Program (ERP) – ought to contribute to improvements in WB's economic governance (see Bonomi, 2016). Mirroring in part the European Semester, the new policy instrument, in addition to more efficient macroeconomic, fiscal and monetary policies, imposes on the WB policy-makers the need to adopt a longer (three-year) planning framework, introduce the prioritisation of structural objectives and an impact analysis of the desired goals. However, only a few countries have for now had the administrative capacity to actually undertake this type of longer-term policy planning and assessment (see Arandarenko et al., 2017).

A major constraint on the implementation of the desired reforms in the WBs are the limited financial resources, especially for investment purposes. Even a radical reallocation of budgetary funds that would substantially increase public investment and reduce consumption-related expenditure would not be enough to provide the necessary resources for investment in those areas that have been singled out as crucial for faster economic development in the WBs. The financing provided by the EU through the IPA

22 The Regional Cooperation Council (previously the Stability Pact for South East Europe – SEE), has been promoting a series of objectives at the regional level, within the Southeast Europe-2020 Strategy that should reinforce cooperation among countries in the region (see: www.rcc.int).

II to the WBs is still rather low and largely insufficient to provide for accelerated economic development. The WBs must be supported with additional financial resources from the EU and its institutions much before they actually fulfil the conditions to enter the EU. Flessenkemper and Reljić (2017) suggest that the WB accession countries "should be granted access to the EU's structural funds, be permitted to participate in the EU's financial stability mechanisms, and be treated in all other respects as part of the European integration project". Major EU financial support could help the aspirant countries to boost their public investment and adopt a clearer developmental perspective. This would be beneficial both economically and geopolitically, not only for the Balkans but also for the EU itself (Bonomi and Reljić, 2017).

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The Experiences of the Visegrad Economies with the FDI Dependent Competition State Model

Zoltán Pogátsa

Executie Summary

- This study looks at the experience of the Visegrad states with the so-called foreign direct investment (FDI) dependent competition state, their varieties of capitalism developed after the economic transition from Soviet style communism in the 1990s.
- It assesses the convergence of these CEE economies to Northwestern Europe (Austria, Belgium, Denmark, France, Germany, Ireland, Netherlands, Norway, UK, Sweden, and Switzerland, simplified in this study as 'Western Europe') in terms of indicators other than GDP, which are more relevant reflections of the welfare level of everyday citizens.
- It finds that contrary to the results of studies concentrating solely on GDP, a multi indicator analysis reveals a slow but definite divergence rather than a convergence.

1. The Foreign Direct Investment Dependent Competition State

During the Cold War, most economic debates were concerned with the rivalry between the "Soviet state planned economic system" and "Western Style capitalism". With the collapse of the former in 1989, attention has shifted to the so-called "varieties of capitalism" debate, which offers almost as much scope for investigation. The basis of this literature is that capitalist societies themselves demonstrate enormous differences in terms of:

- the role of the state (social investment or night watchman),
- the size of redistribution (low to high),
- the extent of industrial policy (non to extensive),
- the nature of industrial relations (trade unions and employers),
- the identity of major economic actors (domestic corporations, SMEs, oligarchs, transnationals, state firms, etc.),
- the financing of firms (bank based or capital market based).

This research programme was started by an edited volume by Hall and Soskice[1], but has since giver rise to a large number of books and studies,[2] which have by and large established the following models:

1 Hall & Soskice (2001).

2 Schonfield (1965), Schmidt (2002), Amable (2003), Albert (1991) etc.

- Anglo-Saxon,
- Continental/Rhineland/Corporative,
- Welfare states (British, German, Scandinavian),
- Development state (European, Latin American, Far Eastern),
- Mediterranean model,
- Petro states,
- Offshore jurisdictions,
- Failed states.

The literature on the Eastern European economies has tried to assess whether the economies of the former Soviet Bloc countries can be fitted into any of the above categories. The absence of industrial policy, weak industrial relations, weak investment by the state into human capital would all place them in the Anglo-Saxon model. However, the reliance on transnational foreign direct investors rather than capital market based domestic champions questions this categorisation. As a consequence, the literature has concluded that these states do not fit into any previous category, and constitute their own variety of capitalism, dubbed as the "FDI dependent economy" by Nölke and Vliegenthart.[3] This model is characterised by an over reliance of transnational FDI for development, and the notable weakness of domestic actors, industrial relations and state policies (including industrial policy). Another useful category is the so called "competition state", as defined by Cerny.[4] These states think of themselves almost as rival firms, sometimes even using similar rhetoric, and compete for international investments. These are the categorisations used by comprehensive studies of the region.[5]

It must be stressed at this point that the former Yugoslav republics, which are now members of the European Union, Slovenia and Croatia, have chosen a different path. Slovenia has become more similar to the domestically owned corporatist model[6] of Austria, with even a high degree of state ownership. Croatia on the other hand has developed towards the Italian/Greek model of Mediterranean capitalism, with a relatively closed economy and a large number of family firms. Slovenia showed a steady line of development until its crisis that was connected to membership in the eurozone. Croatia is characterisable by a debt crisis, as are Italy and Greece.

3 Nölke & Vliegenthart (2009).

4 Cerny P. G. (1997).

5 Pogátsa (2016), Magyarország politikai gazdaságtana – a Skandináv model esélyei (2016), Bohle & Greskovits (2012).

6 Pogátsa (2012), Slovenia: The Only Successful Case of Economic Transition.

2. Assessing the Success of the Model

The nearly three decades after transition and more than ten years after accession to the European Union provide enough scope for reflections on the extent of convergence between former state socialist economies and the developed capitalist economies of Northwestern Europe. The benchmark for successful convergence is West German, which grew from its complete economic annihilation after WW2 to the famous German economic miracle in the sixties, or countries such as South Korea and Singapore, which in three decades developed from Third World to First World economies. As we shall see, no such convergence has occurred in the former Soviet Bloc states.

Frequently these assessments of convergence[7] have been based on a single indicator, primarily the per capita Gross Domestic Product. These assessments usually arrive at the conclusion that the Central Eastern European (CEE) enlargement has been successful, since convergence can be demonstrated for most economies of the region. This leads to triumphalism from the part of national governments and the EU institutions[8] alike. Their optimism is in sharp contrast with the actual political economic developments on the ground. Most states in the region face rampant corruption, political crises, social unrest, low fertility rates and increasing outward migration. What explains this apparent contradiction between the supposed economic success and the weak socioeconomic performance experienced by citizens?

I argue that if we take a more holistic approach and base our analysis on more than a single economic output indicator, we can understand why the superficial phenomenon of convergence is in fact a mirage. While GDP/capita is obviously a valid and important figure, it demonstrates only a single element of a very complex picture: how much new value is produced in an economy in a given year. It says nothing about how that new value is distributed in society between profits, wages and taxes, which is not a trivial question in a region where owners of capital are often foreign investors, and where 'dependent competition states' race each other to the bottom with low taxes and low wages. The GDP figure also says nothing about how many wage earners there actually are (the employment rate), or the distribution of income be-

7 Darvas (2014), Cueresma (2012), Oberhofer, Smits, & Vincellette.

8 See for instance a speech by Lorenzo Bini Smaghi, member of the executive bord of the ECB; http://www.ecb.europa.eu/press/key/date/2007/html/sp071001_2.en.html.

tween those households earning wages. Or how fast have prices have caught up? How are these indicators converging with the developed states of Northwestern Europe? (The 'EU average' served well as a convergence anchor initially, but since the economic collapse of the Southern European periphery this average is too low a benchmark for the CEE region.) To arrive at a complete picture we must examine all these dimensions of convergence, and more.

3. Employment

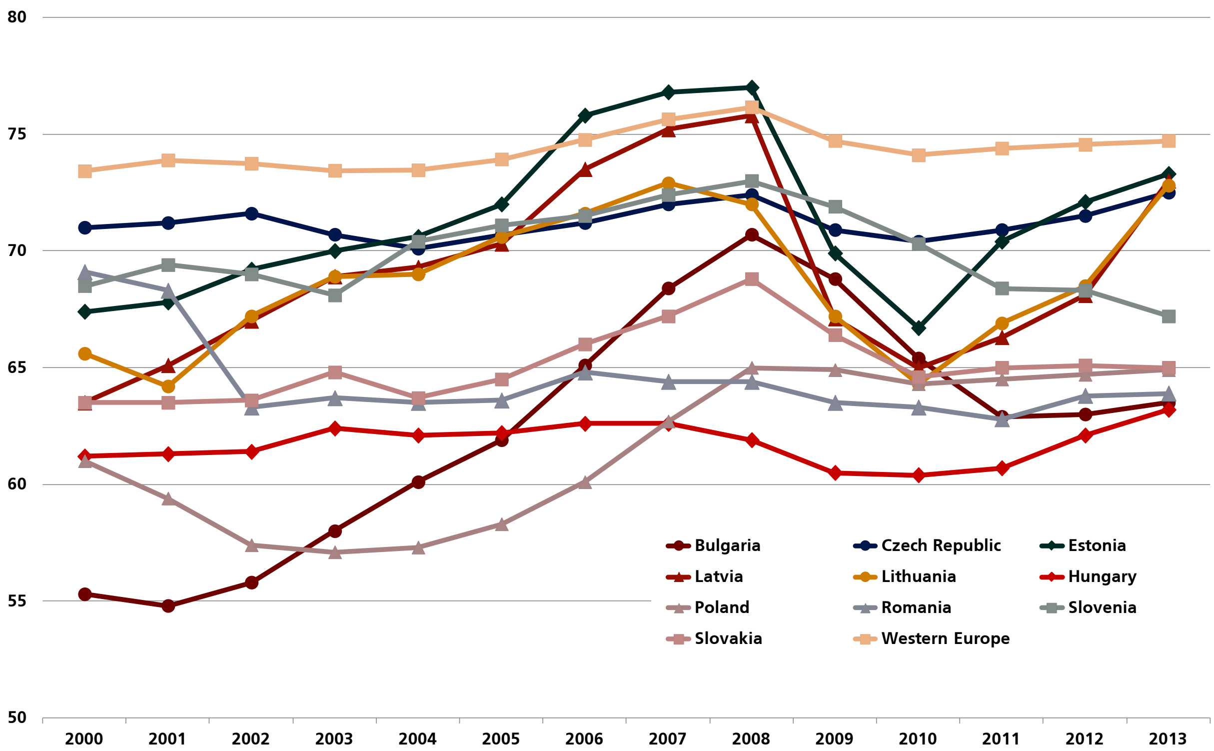
After the GDP/capita indicator, the first and most important question for the CEE countries is how many citizens actually hold a job in these economies? What percentage of the adult population are taxpayers, and thereby contribute to the sustainability of the national budget and the social redistributive systems? (I take the view that state employed taxpayers are in no way less inferior to private sector ones. While it is true that their salaries are paid from tax revenues, the private sector would in turn be unable to produce any wealth without state and local government services. A hypothetical separation ignores the intimate real life symbiosis between them, and how one would collapse without the other.) How does their level of employment compare to 'Western Europe'?

It can be seen from the graph that in 2012 no CEE country reached the Western European average. Their employment levels were in the 62–72% range, with Northwestern Europe continuously averaging around 75% (with roughly a 67–82% spread). Employment in certain countries by and large stagnated (Hungary, Romania, Czech Republic). The only two countries that had levels of employment comparable to Western Europe were the Czech Republic and Slovenia. The latter is the only former socialist country that transformed itself, not into a dependent FDI based economy, but a coordinated, corporative Rhineland model[9] economy.

As is visible from the chart, the three Baltic economies and Bulgaria played roller coaster with the jobs of their citizens: they show a significant increase, then decline. This is likely to be related to their significant levels of outward migration of guest workers to Western Europe before the Great Recession. The small size of the individual Baltic labour markets also might serve to explain the phenomenon, as the collapse of even a single industrial sector can have a dramatically greater effect on the entirety of a small economy. West-

9 Hall & Soskice (2001), Pogátsa (2012).

Figure 1: Employment rates in the CEE and the Northwestern European average (own calculation)



Data source: Eurostat code t2020_10

ern European economies have significantly higher employment stability compared to these unstable labour markets.

As for Slovakia, before the 2008 crisis it basically caught up with its pre-restructuring levels of employment that characterised the country before the Dzurinda reforms (1998 = 67.4 %) before the 2008 crisis. Slovak employment decreased, finishing the period only slightly higher than at the turn of the millennia. These empirical data contrast with the buoyant narrative that had surrounded the Slovak economy before Poland took over as the star student of the region during the crisis years. Poland itself, in spite of its alleged economic miracle during the Great Recession years, never again managed to reach its 1998 employment rate of 65.4 %.

All in all, significantly, the new member states as a group remain decidedly below the Western European levels of employment. It is difficult to observe a convergence process in this group.

4. Incomes

For those holding a job in the CEE region, actual incomes are the next most important issue. In addition, national and local budgets are financed to no small degree from the tax base of those with an income. It is therefore important to ask how much wage earners in the CEE region actually earn? How does this compare with Northwestern European levels of income over time?

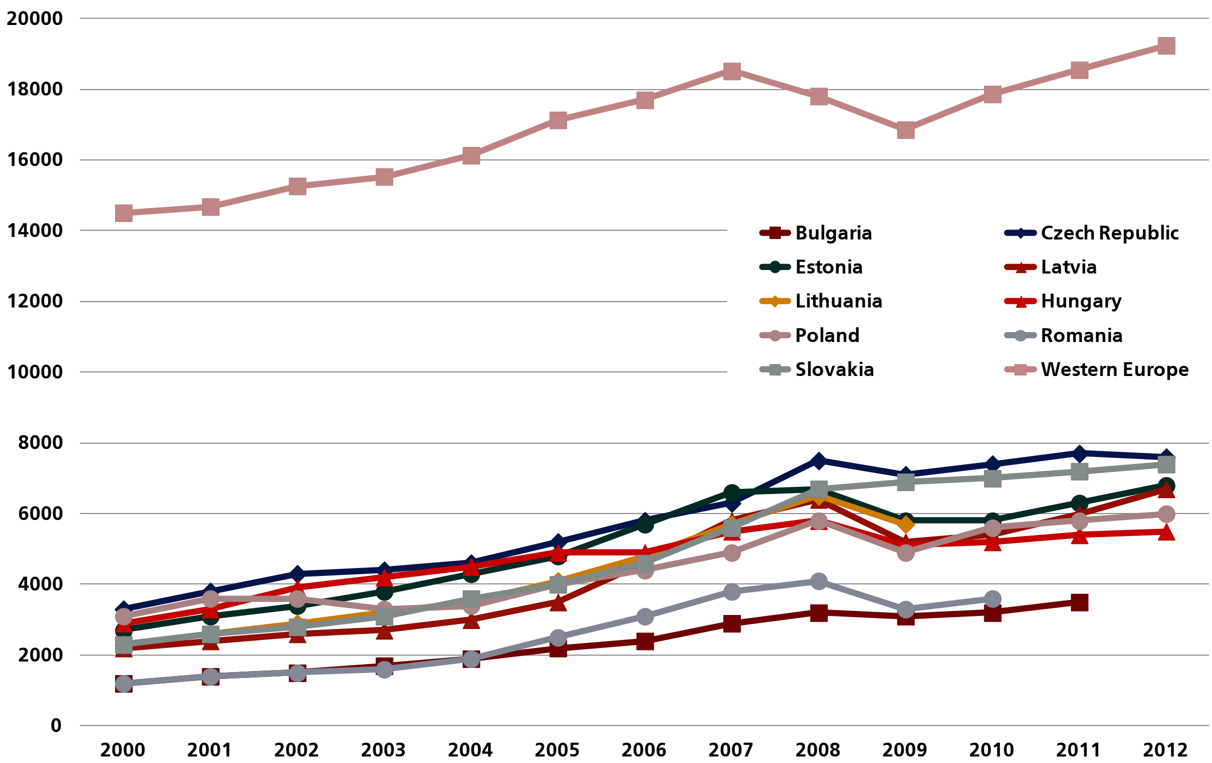
While Eurostat publishes up to date, sometimes quarterly or monthly statistics about business indicators, it is far less helpful as a source of social indicators such as income. The best proxy we can work with is total actual individual household consumption.

At current prices, the only country that had achieved a slight positive convergence (of about 367 euros) with Northwestern Europe by 2013 was Slovakia. Hungary and Poland had suffered considerable divergence (2.133 euros and 1.833 euros respectively), while all the others gone through a slight divergence.

Naturally, consumption levels cannot be accounted for at current prices, they need to be brought to purchasing power parity. Price levels play a decisive role in how much these earnings are worth in a given economy. Here, however we run into difficulties because the officially published price level indices of Eurostat are contestable.

Even the official 'actual individual consumption' price level statistics of Eurostat indicate a very rapid price convergence, much faster than that of consumption itself.

Figure 2: Total household consumption expenditure at current prices, CEE and Northwestern Europe (own calculation)



Source of data: Eurostat code nama_co3_c

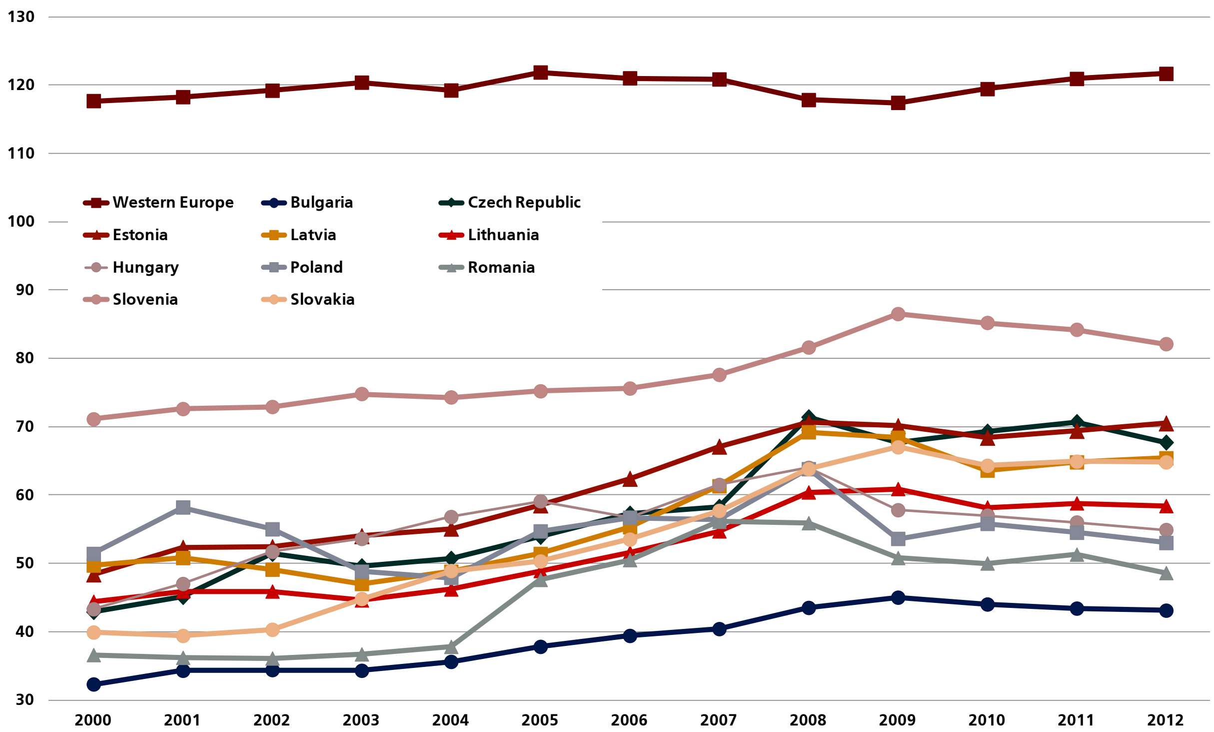
Thus if we base our assessment on these official figures, we can conclude that while there was a mild divergence in nominal consumption, there was simultaneously a very rapid convergence in prices from about a third of Western European prices to about half. However, it is questionable whether this indicator is really a correct approximation of actual consumption price levels. It is very likely that it undershoots actual consumption price levels, if we look at its components. A simple weighted average of the dominant elements of a household consumption basket yields a price level closer to two thirds of Western European levels rather than half.

It is hard to see what component of what supposed consumption basket yields the official overall 'actual individual consumption' price level index when its most important components are higher in value. One possible candidate could be rent. However, Eurostat does not publish a component index for rent alone, which is in itself problematic.

The Eurostat handbook[10] provides explanations about these discrepancies. One problem is that the methodology does not use simple weighted averages, which means that services such as 'hotels and restaurants' are over weighted in the price indices. (CEE citizens usually hardly spend any nights in hotels in their own countries, and a major proportion of them cannot afford to regularly dine in restaurants.) Even more significantly, the official price indices contain price levels for government services that are not directly purchased by households from the market, such as education or healthcare. In CEE economies, prices in these sectors are very low, mostly due to low wages. The underlying assumption of this methodology is that cross county comparability is only ensured with countries where these services have to be purchased on a market basis if the cost of services is taken into account even in countries where they are provided free of charge by the state. However, this assumption is flawed. First of all, there are almost no such extreme market based economies within the European Union, as health and educational services are available free of charge in most EU member states, or at least operate in a parallel manner, in that one can buy supposedly higher quality services privately, alongside free public service. Even more importantly, it is mistaken to assume, as the 'no free lunch' argument often does, that public services are at the end of day financed by households through taxation. There are plenty of other sources of state revenue that can finance 'free' government services. They include taxes on profits, wealth, excise, environmental degradation and others. Consider-

10 OECD/European Commission (2012).

Figure 3: Actual individual consumption price level indices of CEE and Northwestern Europe EU member states (latter own calculation), EU27 = 100 %.



Source of data: Eurostat code nama_co3_c

Table 1: Component price level indices, EU27 = 100 % (2012)

	CZ	HU	PL	SK	EE	LV	LT
A. Actual individual consumption	***67,7***	***54,9***	***53***	***64,8***	***70,5***	***65,4***	***58,4***
B. Food and non-alcoholic beverages	83,7	80,8	61,6	86,7	86,6	87,1	77,4
C. Electricity gas and other fuels	90,8	81,3	71,1	96,4	74,3	76,1	81,4
D. Transport services	66,4	65	57,3	55,1	73	68,1	58,7
E. Communication	112,6	111,9	70,1	125,4	72,4	81,2	58,3
F. Hotels and restaurants	58,2	50,1	74,9	70,9	76,3	80,7	63,6
Average B-E	***88,375***	***84,75***	***65,025***	***90,9***	***76,575***	***78,125***	***68,95***
Average B-F	82,34	77,82	67	86,9	76,52	78,64	67,88
Residential buildings	65,1	49,6	56,7	64,2	70,5		

Source: Eurostat code prc_ppp_ind

ably lowering the price indices by including these governmental services therefore introduces an unjustifiable downward bias. The actual consumption price indices are more likely to be in the range of 80–85 %, as represented by the direct market based household expenditure components published by Eurostat.

5. Distribution of Incomes

Given that Visegrad and Baltic citizens nominally earn on average around a third of what Westerners earn, yet their prices are half to two-thirds of Western ones, we have a situation where a typical Eastern household is forced to spend almost all of its income on basic consumption. This average Eastern household is about the seventh tenth of society. This means that only the top deciles really have savings in the CEE region.

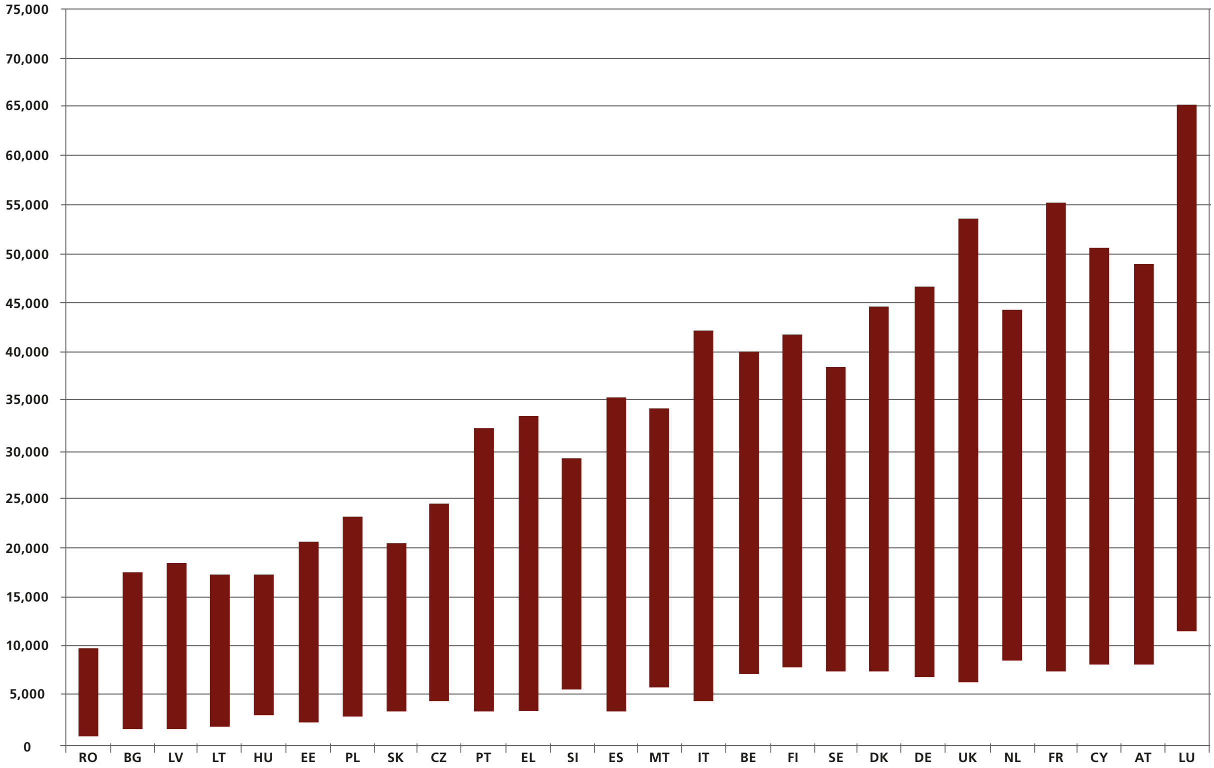
The Eastern European average corresponds to the lowest two deciles of Western European income distribution. These are the only two deciles of Western society that do not have significant savings after basic consumption on food, energy, housing and transport. The lowest tenths of CEE societies continue to live in extreme physical poverty, which is almost non-existent in Northwestern Europe.

As far as minimum wages are concerned, they provide no more than a facade of a welfare arrangement in the region. As can be seen from the graph below, statutory CEE minimum wages are around 1/4–1/5 of Western European minimum wages. Many Western European countries, such as Scandinavia, do not have general minimum wage levels. Instead, they agree on industry specific wage floors, which fulfil the same purpose, only in a more differentiated way. These industrial wage floors are mostly higher than even the statutory Western European minimum wage levels. Therefore, taking these countries into account, minimum wage levels in Eastern member states, approximate more a 1:5 rather than the 1:4 ratio. Given that the price levels can be approximated at around around 2:3 of Western price levels, it becomes clear that CEE minimum wage levels are so extremely low that they become meaningless in terms of social protection. In fact in almost all cases they fall below the official subsistence minimum published by National Statistical Offices.

6. Productivity Divergence as a Basis for Wage Divergence

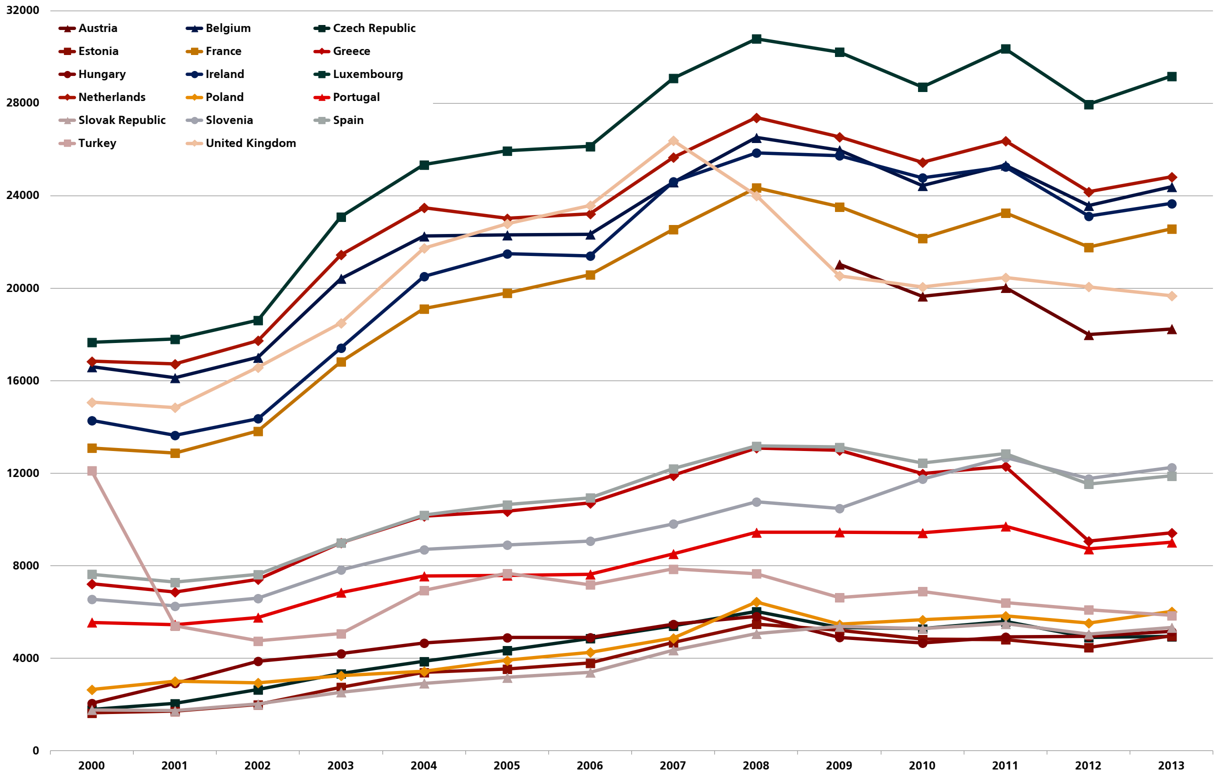
It is also important what defines the dynamics of wage growth. The central prospect of both economic transition and EU accession was the gradual convergence of incomes with Western Europe in the medium time range (i. e. within a generation or so). There was no expectation of full convergence, which would have been insensible from an economic point of view. What was expected was a noticeable, gradual process, much like what has actually been taking place in terms of GDP. (It is telling how in spite of Eastern GDP levels actually approximat-

Figure 5: Income distributions across Europe, in € at official Eurostat PPS, 2010



Source: EU-SILC

Figure 6: Official statutory minimum wages in European countries



Source: OECD Labour Statistics

ing and in some cases overtaking Southern member state levels, actual household income levels remain far lower.) Since the populations of the region are not experiencing this convergence, it is important to examine the underlying factors. Apart from negotiation between employers and employees, it is productivity that determines wages. Extreme and continued wage increases beyond productivity increases, price out an economy in international competition.

Naturally, productivity in a given economy is distributed across a range. This in itself is significant. Why do Eastern European societies have such flat income distributions, when their productivity distributions are quite likely to be wider? That is a question that begs for an answer. Productivity distributions, however, are not available, only national averages. Economy wide average productivity is estimated by dividing aggregate GDP by the number of employed, or the number of hours worked in the given economy.

What can be observed from the graph is that the productivity gap between CEE and Western Europe actually increased before the crisis, only to drop slightly between 2007 and 2009. After that, divergence resumed. Over the whole period the region diverged by some 1–3 euros. The worst performer, Bulgaria, an outlier, diverged by 4.3 euros in this period.

Productivity is a crucial underlying factor because it determines wages. Therefore it is extremely important to understand what we are measuring, and its dynamics. The first key precondition is that because it is calculated by using the aggregate GDP figure, the GDP figure should be accurate. However, we can be sure that this is not the case. Since the region is dependent on transnational foreign investment, we must calculate with the massive effects of transfer pricing by these transnationals. According to a well-respected report[11] by an NGO dealing with offshore leakages, The Tax Justice Network, several of the economies of the region are amongst the greatest losers of the global offshore network. Thus the actual GDP of these countries, and by inference their actual productivity levels must in fact be higher than the official statistics suggest. If wages are to conform to real productivity levels, the existing wages are too low (Dicken, 2003).

What we see on this regression line is that there seems to be a very close correlation between productivity and wages. As I have already mentioned, if an economy moves too far above the trend line, it is going to price itself out. Seemingly the economies of the region lie close to the regression line, which suggests that all is well with incomes. (Slovakia is a noticeable outlier.) This regression line, however, is not an explanation for diverging productivity levels of the CEE economies, but a graphical representation of it. There is still a need to explain what it is that accounts for the productivity divergence.

Productivity is related to both labour and capital.[12] It is often assumed that it is the human capital of the region that explains the level of productivity. This claim can now be empirically tested with the help of the OECD's Programme for the International Assessment of Adult Competencies (PIACC). Like its better know sister programme, PISA, it measures the same numerical, computational and problems solving capacities. It does so, however, amongst those already employed, rather than students. This means that PIACC is an optimal tool for assessing the human capital of the region, as it measures exactly what we are seeking to find. If the productivity of the region was lower because of the weaker labour market skills of local employees, we would expect to find these characteristics reflected in the PIACC study. The 2013 report[13], however, does not confirm these expectations. High productivity in Northwestern European, North American and CEE economies are mixed in terms of all three competencies. These results seem to indicate that it is not the human skills of labour in this region that serves as an explanation for lower levels of overall average productivity.

Numerous alternative explanations could be offered, but it is high time economists dealing with the region addressed these issues. Here I offer one possible explanation. As I have already mentioned, Western European economies have minimum wage levels (or industrial wage floors) that are around 10–16 euros per hour. It is economically unfeasible to employ labour in those countries at productivity levels per hour that are below these levels of regulated pay. Incidentally, this Northwestern European minimum wage level is above the average income level of the FDI based dependent market economies in Central and Eastern Europe. The minimum wage levels of these countries as far lower, at around 2 euros per hour, or even lower. This leads to what is often referred to as social dumping: the low value added production phases of multinational production chains[14], which create less than this amount of value, migrate towards the low wage East, lowering the average there, thus lowering the country on

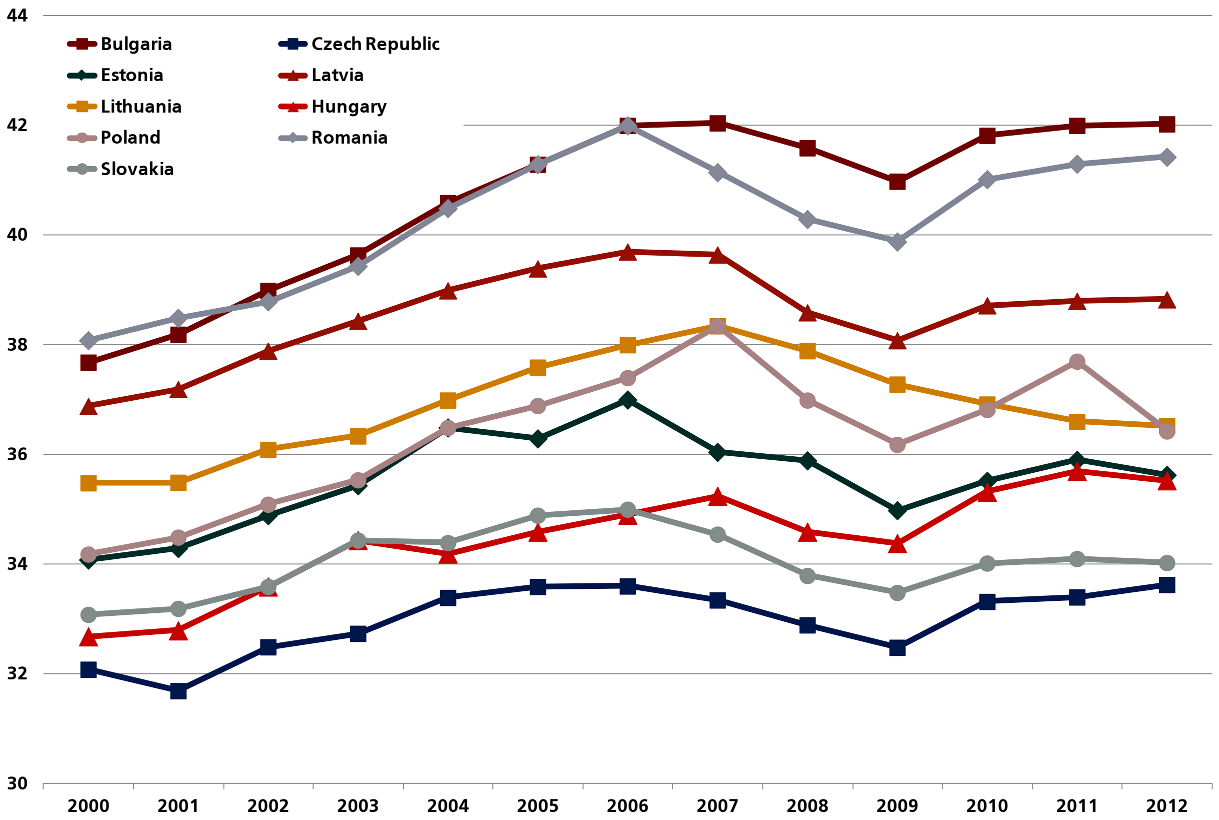
11 TJN (2012).

12 Sraffa (1960).

13 OECD.

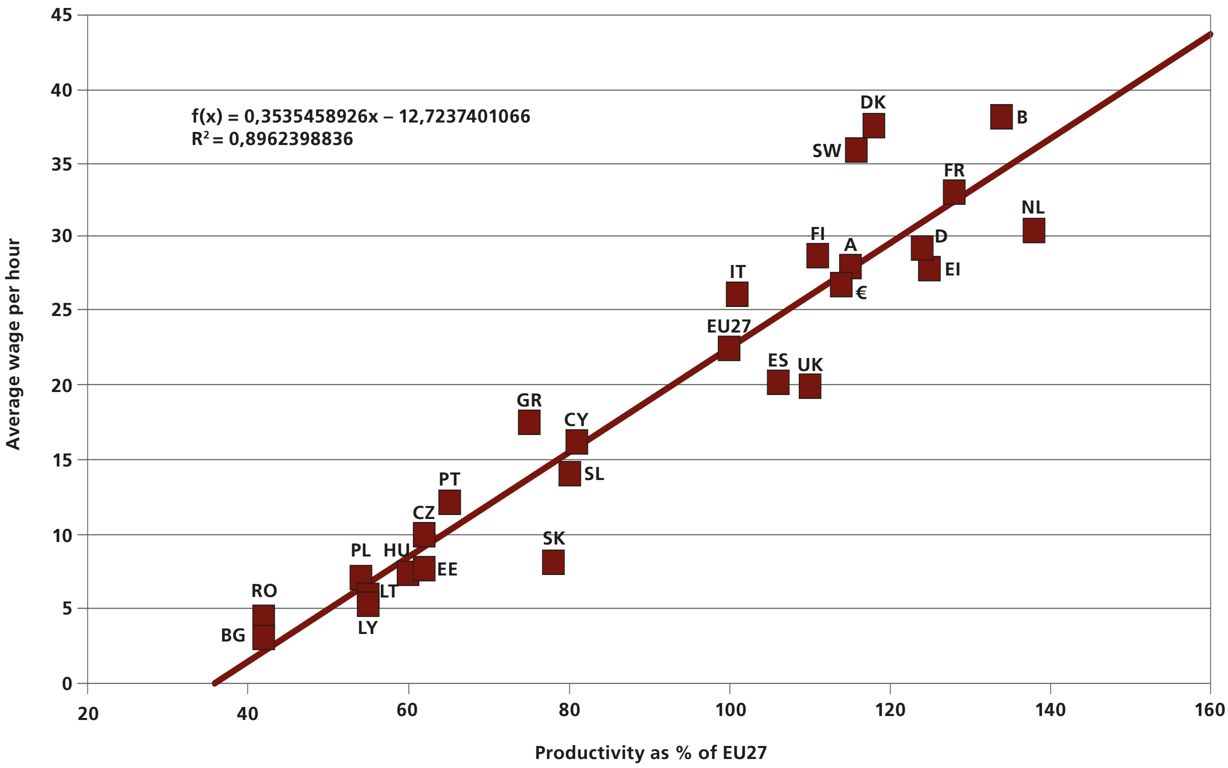
14 Chapter 8 (Dicken, 2003).

Figure 7: The productivity gap between CEE economies and Western European economies, euro per hour worked



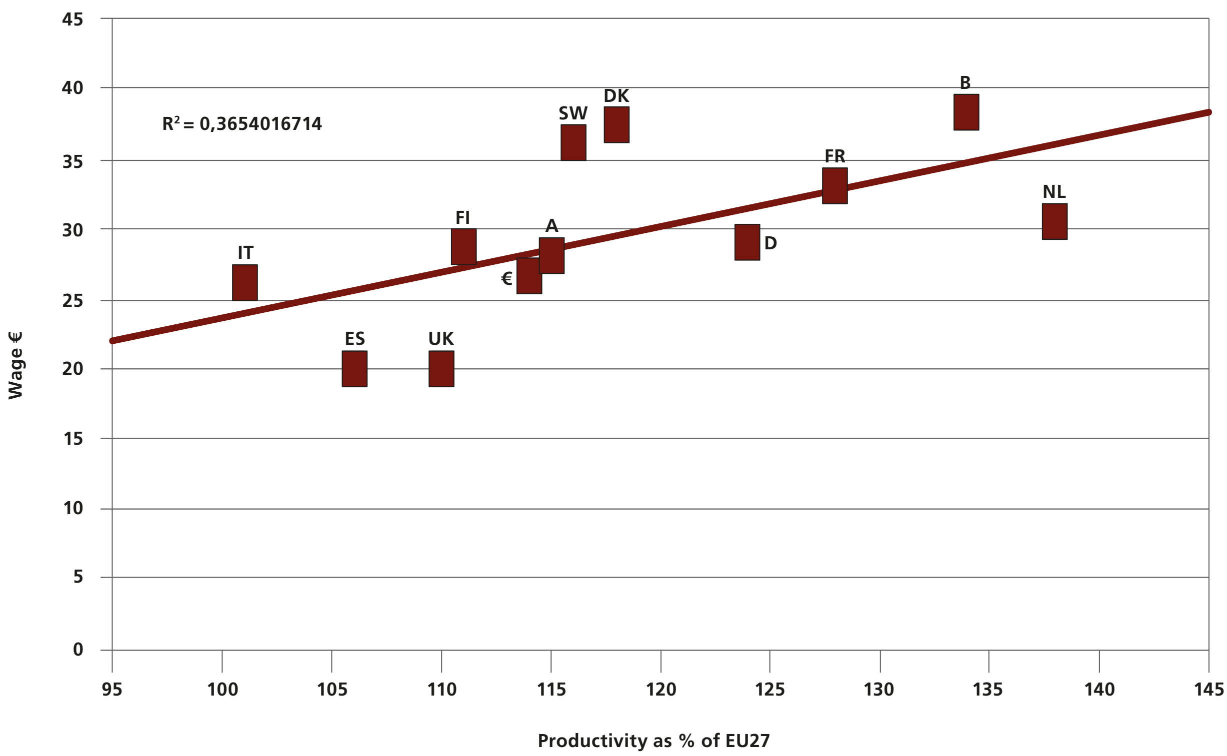
Source: own calculations based on Eurostat code [nama_aux_lp]

Figure 8: Linear regression trend line between productivity as a percentage of EU27 average, and average wage per hour in €, 2010



Source: Own calculation based on Eurostat

Figure 9: Linear regression trend line between productivity as a percentage of EU27 average, and average wage per hour in €, Western European countries, 2010



Source: Own calculations based on Eurostat code [nama_aux_lp]

the regression line. All in all, the East-West wage differential is institutionalised across the European Union by the differential in the minimum wage.

What is very telling is how weak the relationship becomes between the two variables once the CEE countries are eliminated, leaving only the Western European ones.

It is also worth noticing how the regression line becomes flatter. This means that a move down the productivity axis does not bring with it a much faster move down the wage axis, as in the previous graph when CEE economies were also included. From the point of view of wages, a more favourable productivity-wage relationship exists for Western European economies than for the CEE ones.

Finally, it is worthwhile to take a look at the share of profits and wages within GDP across the EU. While neoclassical economics rarely ever concerns itself with the way GDP is divided up between the remuneration of capital and wages, Marxian economics does.

What is obvious from this table is that the profit-wage share in CEE is considerably less favourable than in Western Europe. A smaller ratio of GDP is spent on wages in this region than in the core economies of Europe. If we add to this the fact that the owners of capital are very often foreign entities in the CEE, this difference also has consequences as far as the outflow of capital from the region is concerned.

7. Conclusions

The foreign direct investment dependent competition state has failed to achieve economic convergence with Western Europe, the regional anchor for the centre of the global economy. It has managed to overcome the inefficiencies of the initial phase of economic transition, namely that of crony capitalism, characterised by privatisation to persons close political power. However, the shift to integration into transnational production chains[15] has not brought with it the expected results: high levels of employment, technology transfer and income convergence. Instead, it has integrated these economies into the lower value added production phases of the transnational production chains.

FDI dependent competition states do not have industrial relations or policies. When asked about

15 Dicken (2003).

Table 2: The share of wages in total GDP in Western and Eastern European Union member states

Country	Wage share in total GDP, %	
	Average 2004–07	*Average 2008–09*
Austria	60.6	61.3
Belgium	65.2	67.9
Denmark	69.4	74.7
Finland	61.1	65.3
France	66.2	66.5
Germany	***65.5***	***66.2***
Netherlands	58.4	59.7
Sweden	69.0	68.7
United Kingdom	66.9	66.6
Czech Republic	49.9	51.2
Estonia	57.4	64.0
Hungary	58.2	58.2
Poland	43.6	45.8
Slovakia	43.6	44.0

Source: ILO

how technological change will take place, their answer is the inflow of FDI. When asked about employment, their answer is the inflow of FDI. It is the same for social policy, regional policy, industrial policy, etc. Such an approach has proved itself to be inadequate. We know from development economics that the so-called Solow residual is key in determining economic development. This is constituted mostly by the level of human capital, as well as the ability of the given country to create domestic and absorb foreign technology. In the absence of state policies, poorer economies do not possess adequate household savings to invest into these areas. For convergence to take place, there is a need for the state to invest in education, retraining, health, social policy and public transport. In the absence of this, the human capital accumulation of the region will continue to lag behind. As a consequence, the region will continue to be trapped at lower levels of value added, which prohibits socio-economic convergence.

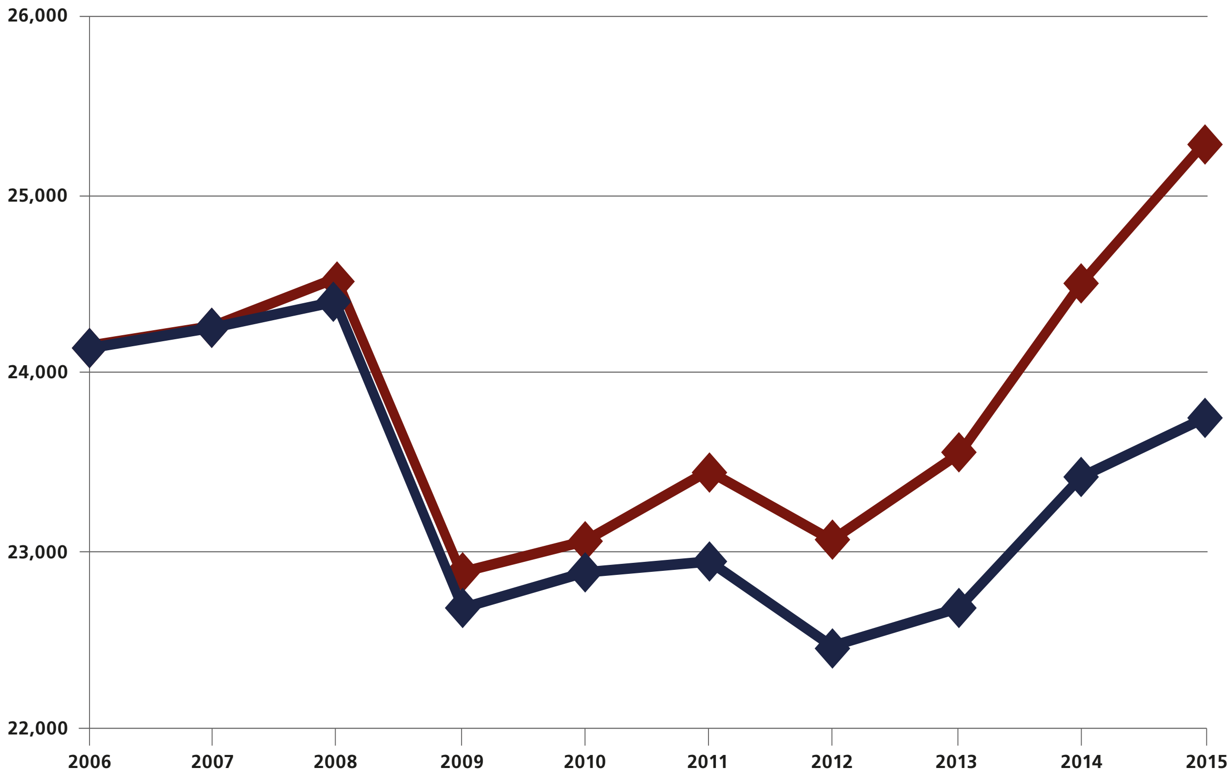
In addition, from a Keynesian point of view, lower domestic wages constitute a lower domestic demand, further contributing to lower employment.

Case Study: Hungary

Hungary was the pioneer of the FDI dependent competition state in the 1990s. However, by the mid 2000, this model had ran its course. It became clear that the low level of employment, low wages and lack of middle class lead to rampant corruption, cronyism, economic populism and political radicalism on both sides of the political spectrum. Hungary became once again the pioneer country in the region, but this time for regression into socio-political self-peripheralisation. This has since been followed by Poland, Slovakia, Bulgaria and Romania as well, and the Czech Republic also exhibits similar signs.

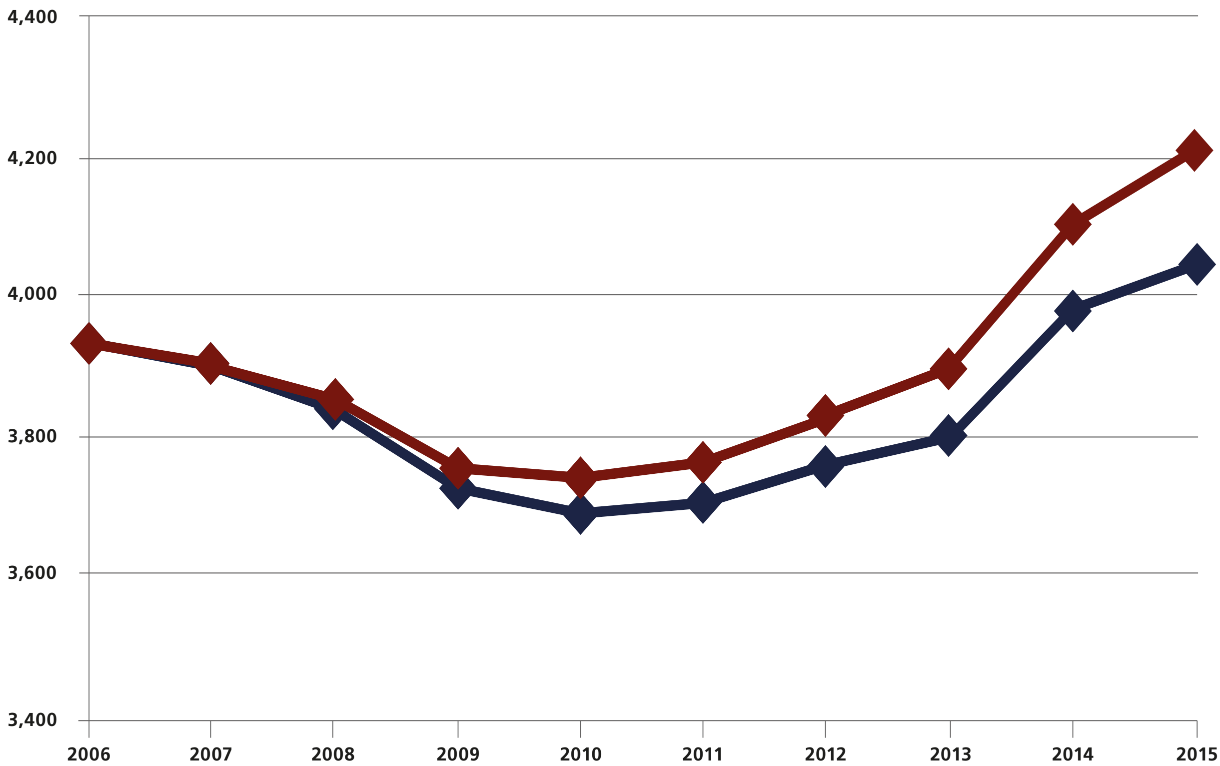
Presently, Hungary is kept afloat economically by European Union transfers. According to a study by KPMG, in the 2007–2013 period Hungary had an absorption rate of 115 % of EU transfers, with other countries in the region having similar rates. In some years (during the Orbán government) Hungary received external transfers amounting to as much as 6–7 % of its GDP from cohesion policy transfers. This has resulted in relatively high rates of growth at 3–4 % annually.

Figure 10: GDP convergence of Hungary with EU transfers (actual – red) and without them (estimated – blue), billion HUF



Source: KPMG

Figure 11: Employment in Hungary (thousands) with the EU transfers (actual – red) and without them (estimate – blue).



Note: The blue line still includes labour migration to the West, as well as extensive public works programmes. Source: KPMG.

However, had it not been for these transfers, KPMG estimates that no GDP convergence would have taken place at all!

The situation would be similar in the other countries of the region as well, given that they also receive about 2.5% of their GDP each year, and their economic growth has been comparable.

Employment has also been boosted by membership in the EU, and without this the region would be in deep crisis. It is estimated by KPMG that about 175 000 jobs have been created as a direct consequence of the demand effect of EU transfers in Hungary. Most EU transfers take place in the construction sector, where in recent years half of all investment has come from this source. Construction is very labour intensive. However, the original aim of EU cohesion policy is structural transformation rather than a net demand effect. Once these windfall inflows disappear, the employment gains prove to be unsustainable.

Another source of improvement in terms of employment is labour migration. With about 6% of its adult population abroad, Hungary has achieved about a 300 thousand people employed in the West improvement in its activity rate and in its unemployment rate. (Labour migration to Western Europe shows up as improvement in the East!) However, it is the country with one of the lowest rates of labour migration. Others, such as Bulgaria, Romania, Poland and Lithuania have seen 15–20% of their adult populations move to the West. This has contributed greatly to the improvement of the employment situation in the East, without making the FDI dependent competition state model any more sustainable.

In addition to the above, Hungary also runs extensive (200–220 thousand employed in public works programmes at any given time) public works programmes, which are basically not tax paying gainful employment, but hiding unemployment from central budgetary resources at miserable levels of pay, with the simultaneous effective elimination of unemployment benefits and retraining. This workfare regime runs completely contrary to common Employment Strategy of the European Union. The European Commission, however, does not possess the necessary competencies to sanction Hungary. Unlike the previous aspects (the demand effect of EU transfers, labour migration), however, this latter issue is Hungarian specific, and not widely practiced in the other FDI dependent competition states.

Thus without the demand effect of EU transfers on GDP and employment, as well as without the opportunity for labour migration, the FDI dependent competition states of the Central and Eastern European region would not have stayed afloat.

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A Coherent Growth Policy Agenda for Bulgaria

Gancho Todorov Ganchev

Executive Summary

- The paper tries to explain why Bulgaria is going through a very difficult period in terms of economic growth and what is behind its inability to implement the necessary macroeconomic and structural reforms. The reasons are related to the global financial crisis, on the one hand and to the economic policy reaction on the other. Both the twin deficit hypothesis and the extreme neoliberal agenda turned out to be inadequate in fostering economic growth. In addition to this, the country has an unrealistic expectation about foreign investment and EU integration.

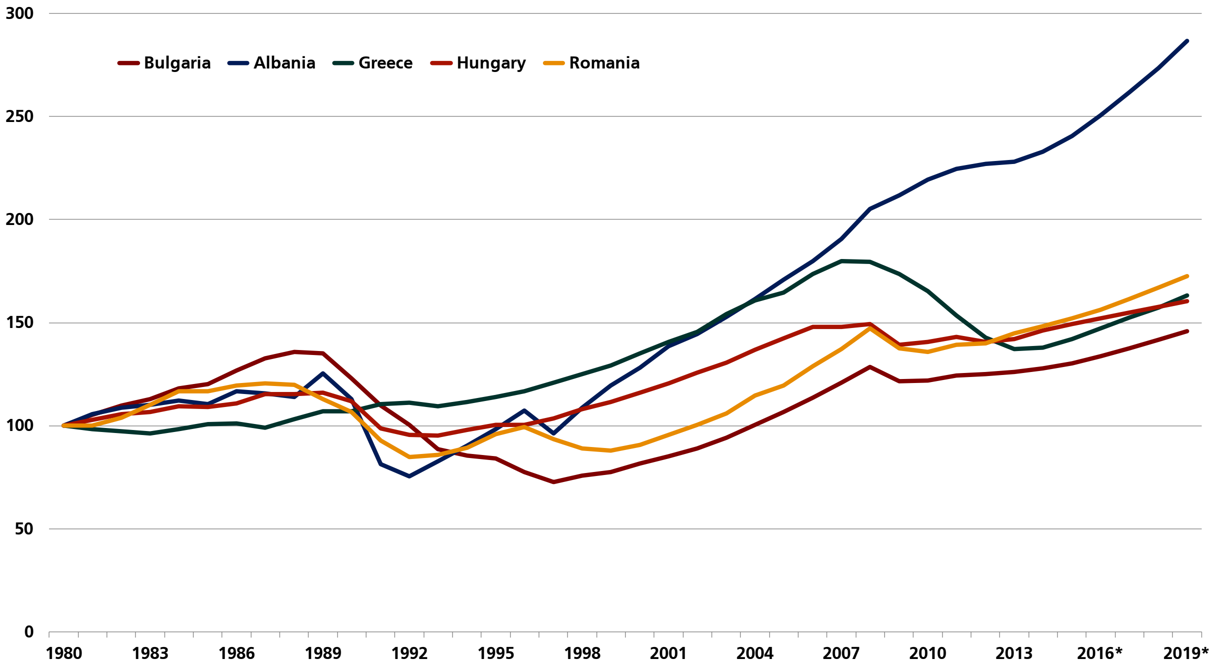
- The author concludes that virtually all economic and social problems of Bulgaria can be reduced to two sources – inappropriate government redistribution and regulation, and a questionable belief that unregulated markets, low taxation, fiscal austerity and monetary non-interventionism automatically resolve all difficulties. The solution requires a new strategy in three main directions: a new macroeconomic setting; optimisation of taxation and redistribution parameters of the economy; and a radical improvement in the transparency, efficiency and accountability of the public sector. Overcoming these obstacles would require strong political direction, coordination with EC, ECB, IMF and other international institutions, and a resilient national consensus.

1. Bulgaria – Long Term Growth Dynamics

In terms of economic dynamics the period 2009–2010, reflects the impact of the global financial crisis, and the current phase illustrates the process of recovery and return to growth. In the case of Bulgaria the period since 1980 can be divided in five sub periods in terms of economic growth (see Graph 1). The first stage is the last command economy episode, 1980–1990. During the first decade (1980–1989) Bulgaria demonstrated the highest growth rate among all selected countries (Albania, Greece, Hungary and Romania). The second period, 1992–1997 (the transitional recession), is characterised, however, by the deepest economic decline among designated countries and perhaps among all post-communist countries, excluding some former USSR states. This is due to the 1996–1997 hyperinflation episode, which was resolved via the introduction of a currency board regime. The period 1998–2008 is marked by the recovery from the protracted transitional recession and the effect of the global financial bubble.

The recuperation of economic growth in Bulgaria, as well as in all selected Southeastern European (SEE) countries, is typified by the so called hysteresis, i.e. the post crisis trend is noticeably less mounting, compared to the pre-crisis rate. The latter feature is distinctive not only for the SEE countries, but for the developed market economies as well (see Blanchard, Cerutti. and Summers, 2015).

Figure 1: GDP at Constant Prices, selected South-East European Countries; 1980 = 100 %



Source: IMF Database; *2015–2019: projections.

From the point of view of the impact of extensive and intensive factors of economic growth it is interesting to distinguish between the role of labour, capital and total factor productivity. As we can see from Graph 2, the number of employed people in the Bulgarian economy follows a cyclical dynamic. The period 2002–2008 is marked by labour intensive growth. After the 2008–2010 crisis employment declined substantially and is still below the pre-crisis level. During the crisis, the main instruments of reducing labour costs were the cutting of employment and the use of flexible wage components (Paskaleva, 2016). Graph 3 shows that on the contrary, the productivity of labour, after some transitory decline in year 2008, resumed a growth at rate, very close to its pre-crisis shape. Consequently, in terms of labour, the 2008–2010 crisis indicates a well-defined transition from extensive to intensive growth.

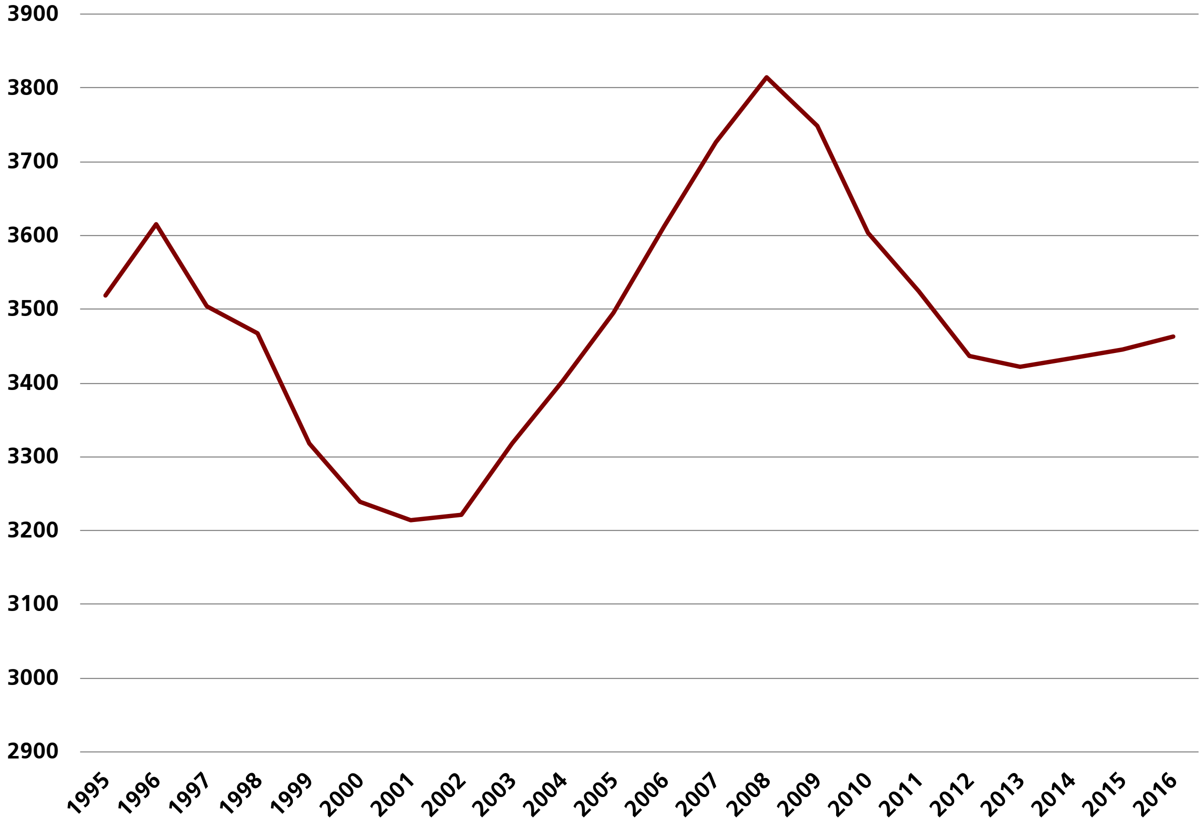
The trends in productivity are not the same for different sectors of the Bulgarian economy (see Graph 4). The industry is the only economic subdivision with strong and sustainable productivity growth. The performance of the services is less impressive, while the productivity dynamic of agriculture is not only unstable, but the GDP per person employed in this sector is still below the pinnacle year of 2004.

For a small open economy, like the Bulgarian one, the role of exports and capital flows is crucial. The instability of exports is not compatible with an export-led growth model. Nevertheless, the expected relatively high and stable exports expansion rates for the next two years reflect the gradual ongoing transformation of exports into an engine of growth. The slow positive structural shifts in exports (see Graph 6), namely the increase of the share of investment and consumer goods at the expense of raw materials and energy, combined with the productivity growth in industry, confirm the former conclusion.

Before the global financial crisis the Bulgarian gross public debt was steadily declining in both absolute and relative terms (see for example Graph 8). In contrast, the indebtedness of the private sector, as well as the volume of the FDI, was progressively increasing. After the crisis, we observe temporarily some increase of the public debt, especially in year 2014, after the crash of the Corporative Trade Bank. The depositors in the bank were compensated via government lending to the Deposit Guarantee Fund. The 2014 financial turmoil led also to contraction of domestic credit (see Graph 9).

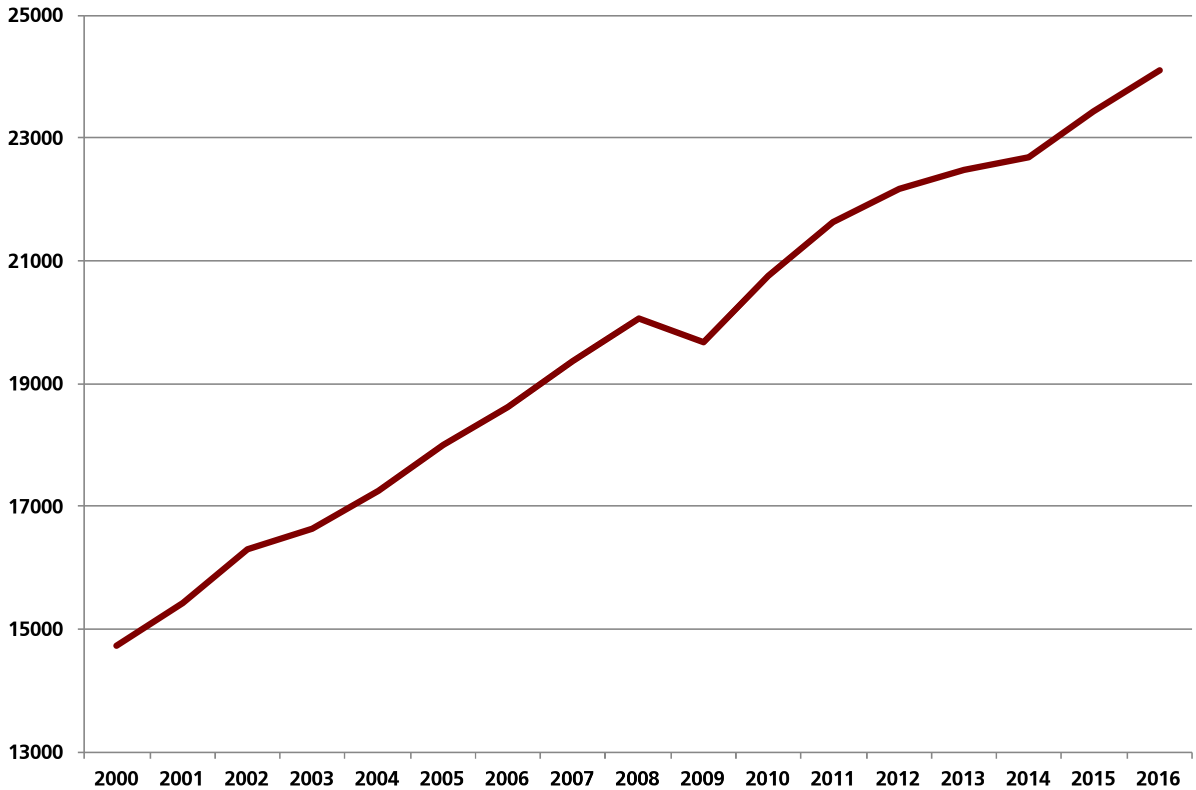
In general however, the trend after the global financial crisis is characterised by the gradual decline of foreign debt (see Graph 10), with the exception of gross public debt. Nevertheless, the net public debt is also declining. So deleveraging is predominant after the crisis.

Figure 2: Employment (in 1,000 Workers)



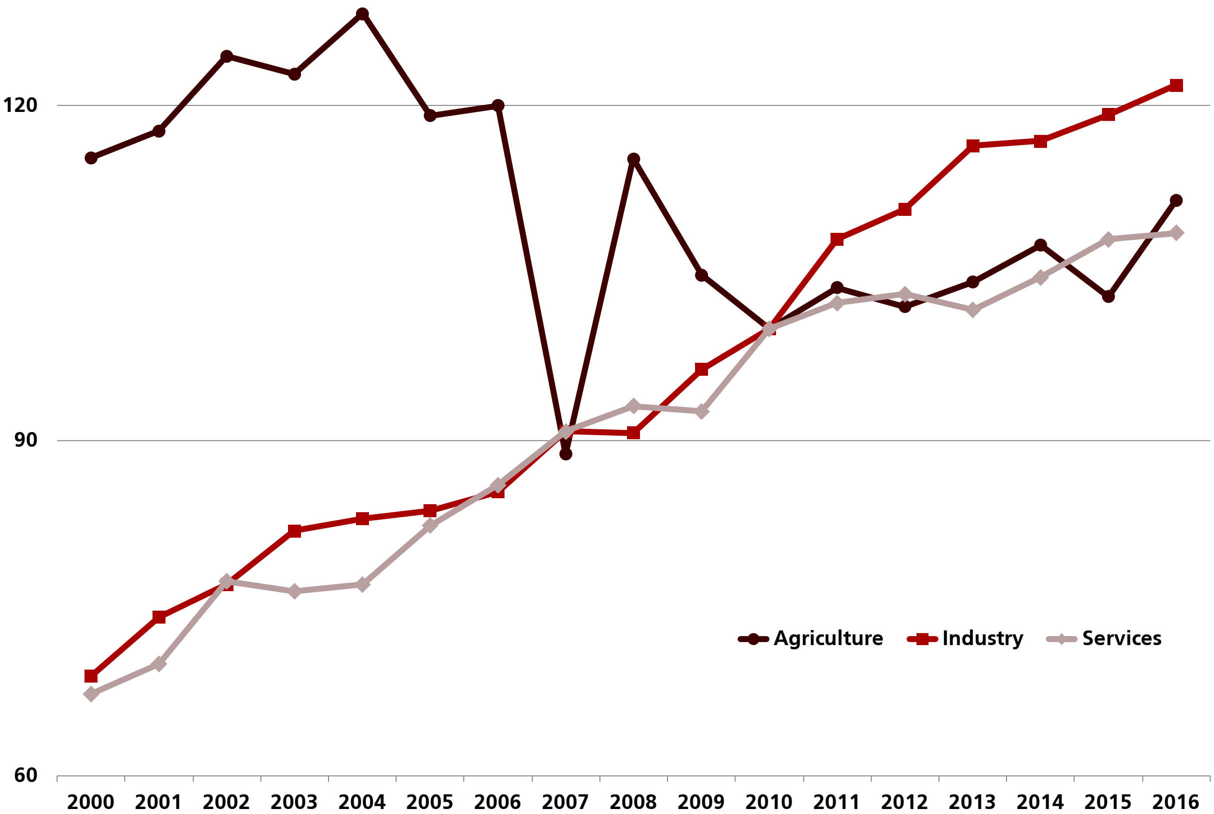
Source: National Statistical Institute.

Figure 3: Productivity in Terms of GDP per Worker at 2010 Prices



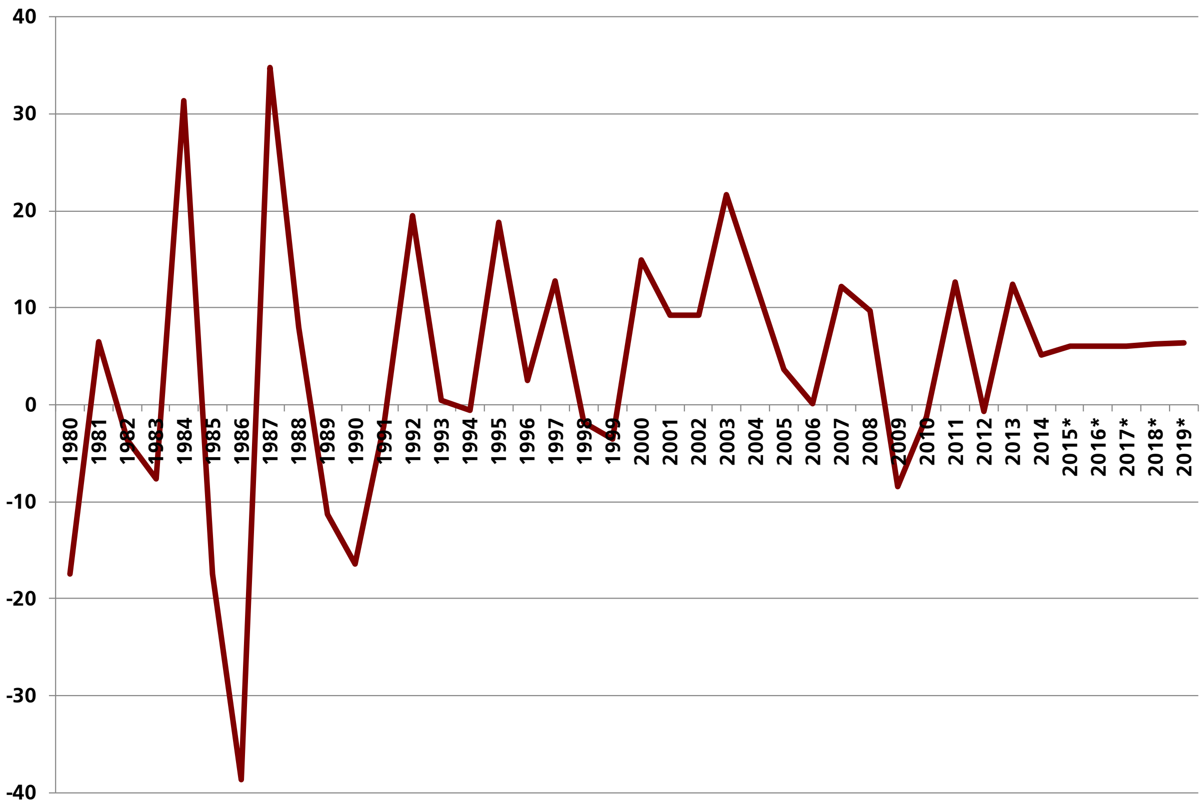
Source: National Statistical Institute.

Figure 4: Productivity in Terms of GDP per Worker at 2010 Prices in the Main Sectors of the Bulgarian Economy



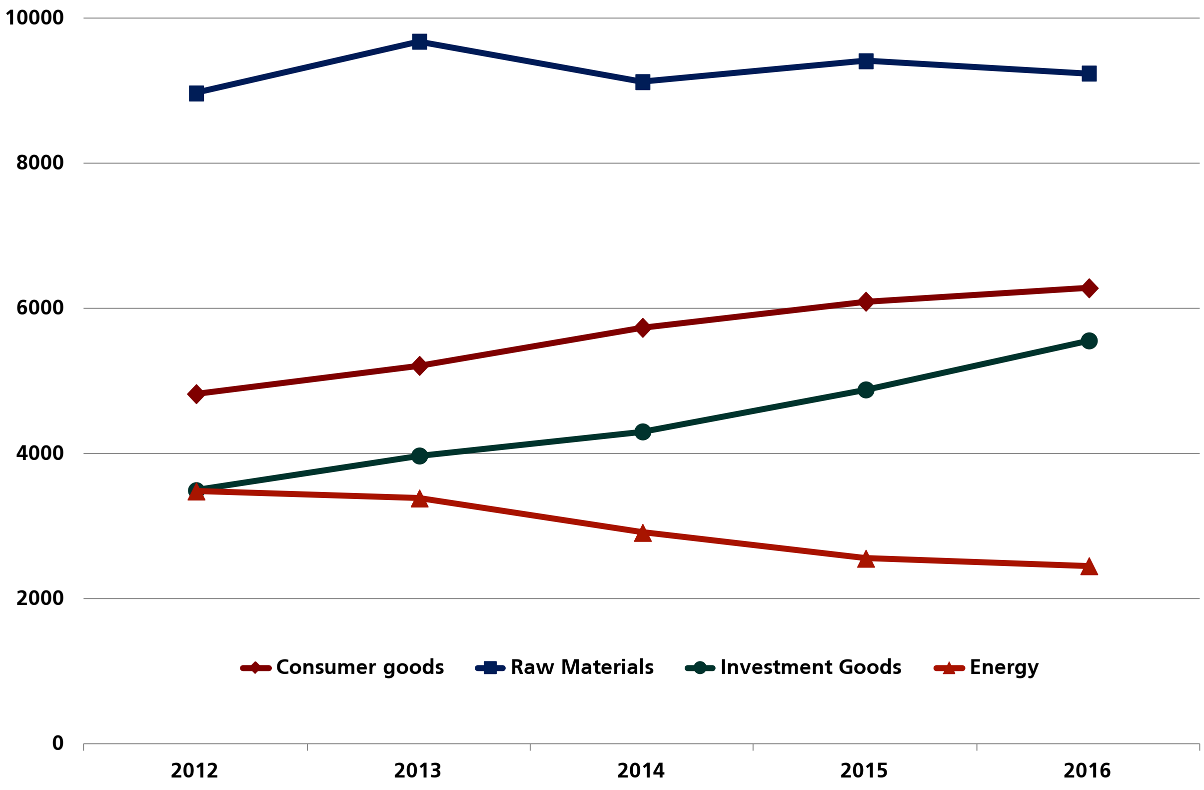
Source: National Statistical Institute.

Figure 5: Annual Persentage Change of the Volume of Exports



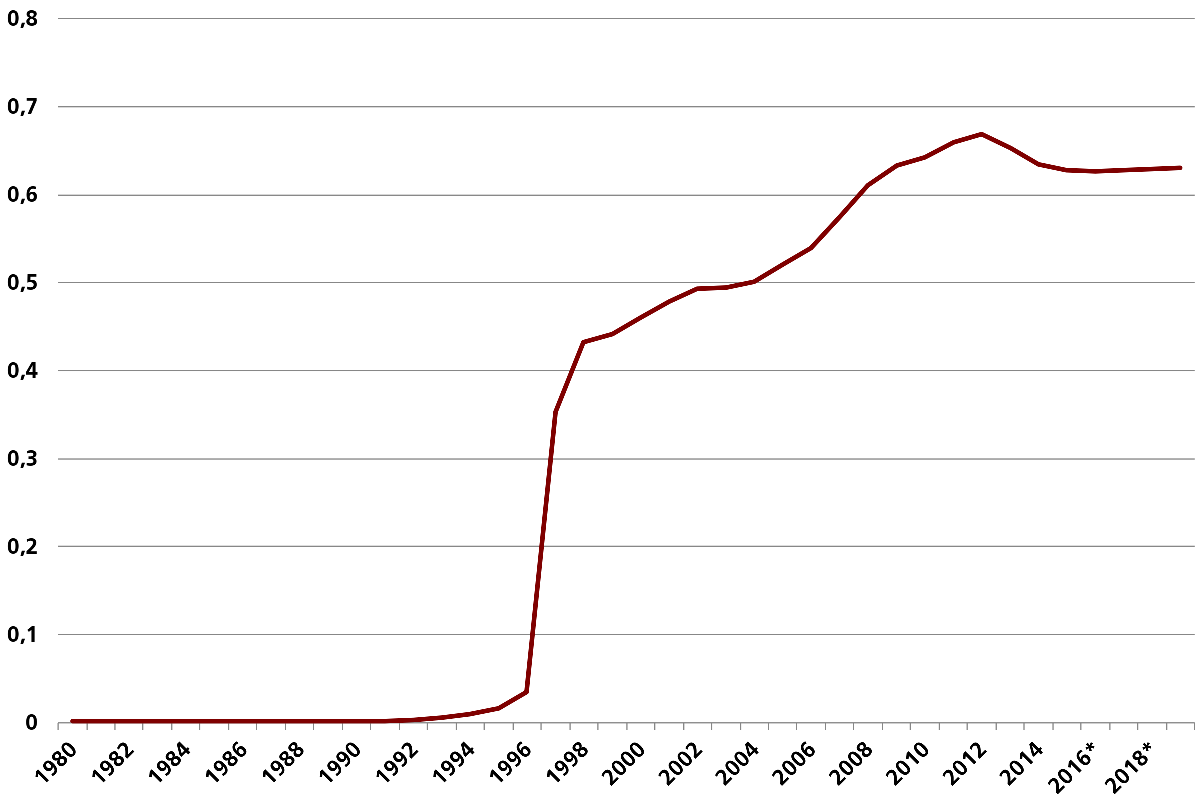
Source: IMF Database.

Figure 6: The Volume of Exports (in 1,000 euro)



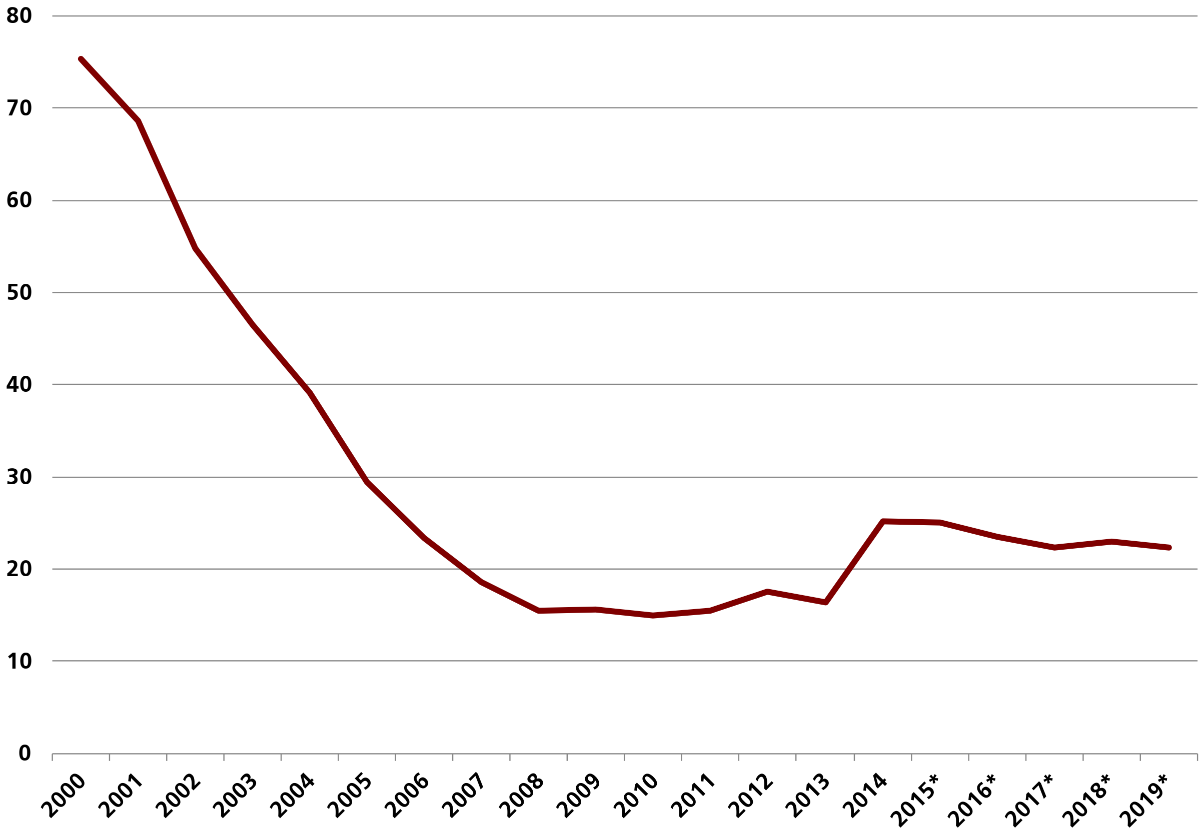
Source: Bulgarian National Bank

Figure 7: Implied PPP Conversion Rate, in National Currency per International Dollar



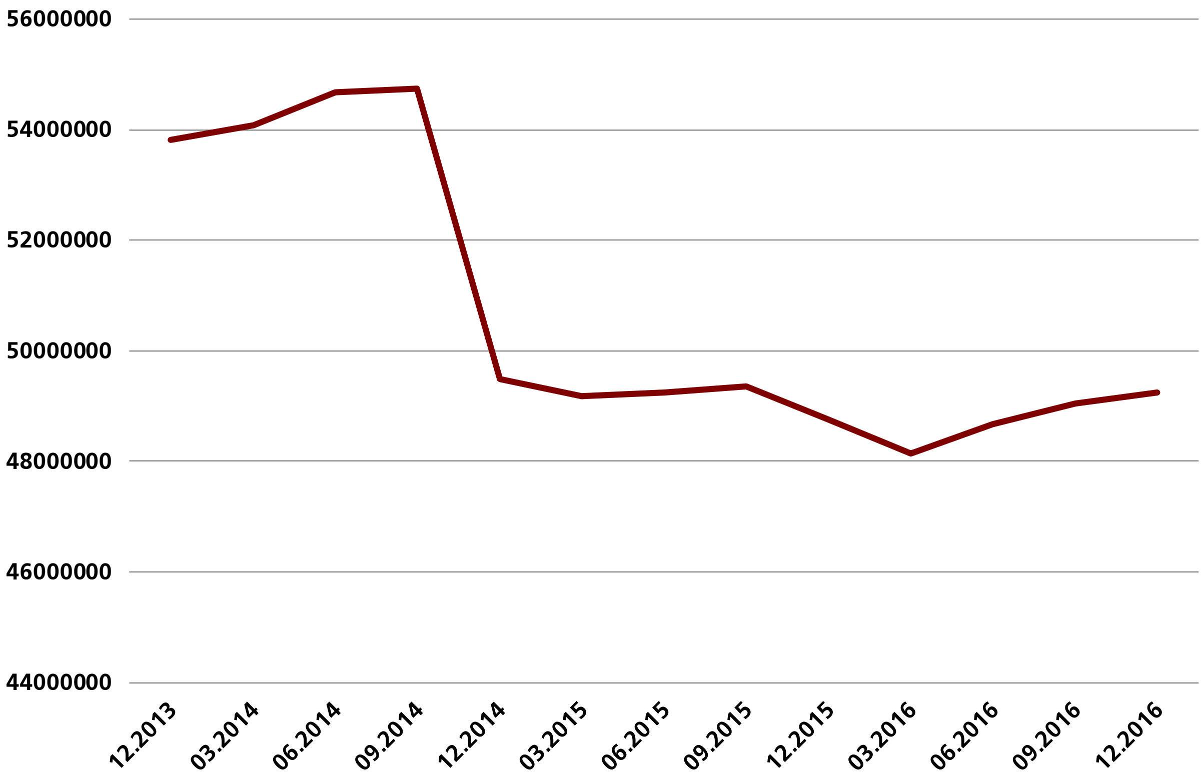
Source: IMF Database

Figure 8: General Government Gross Debt in % of GDP



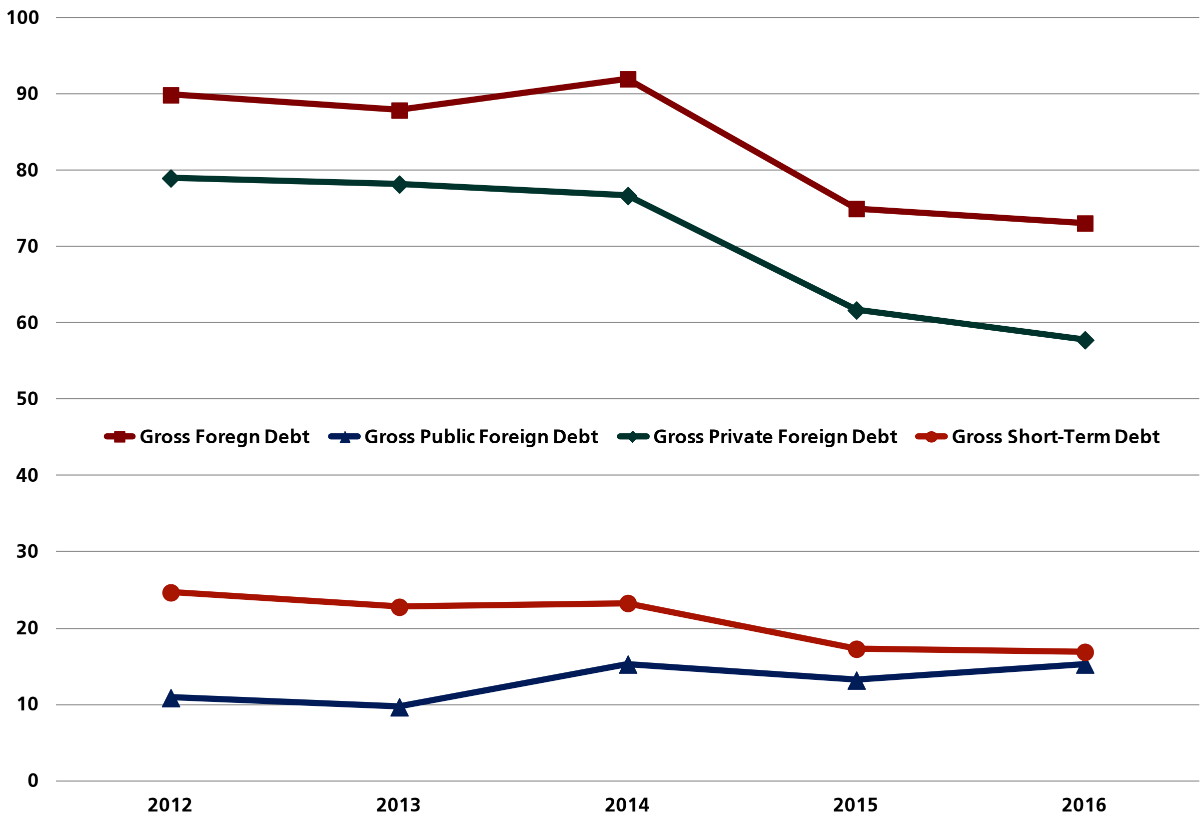
Source: IMF Database

Figure 9: Lending to Non-Financial Enterprises and Households (in 1,000 Leva)



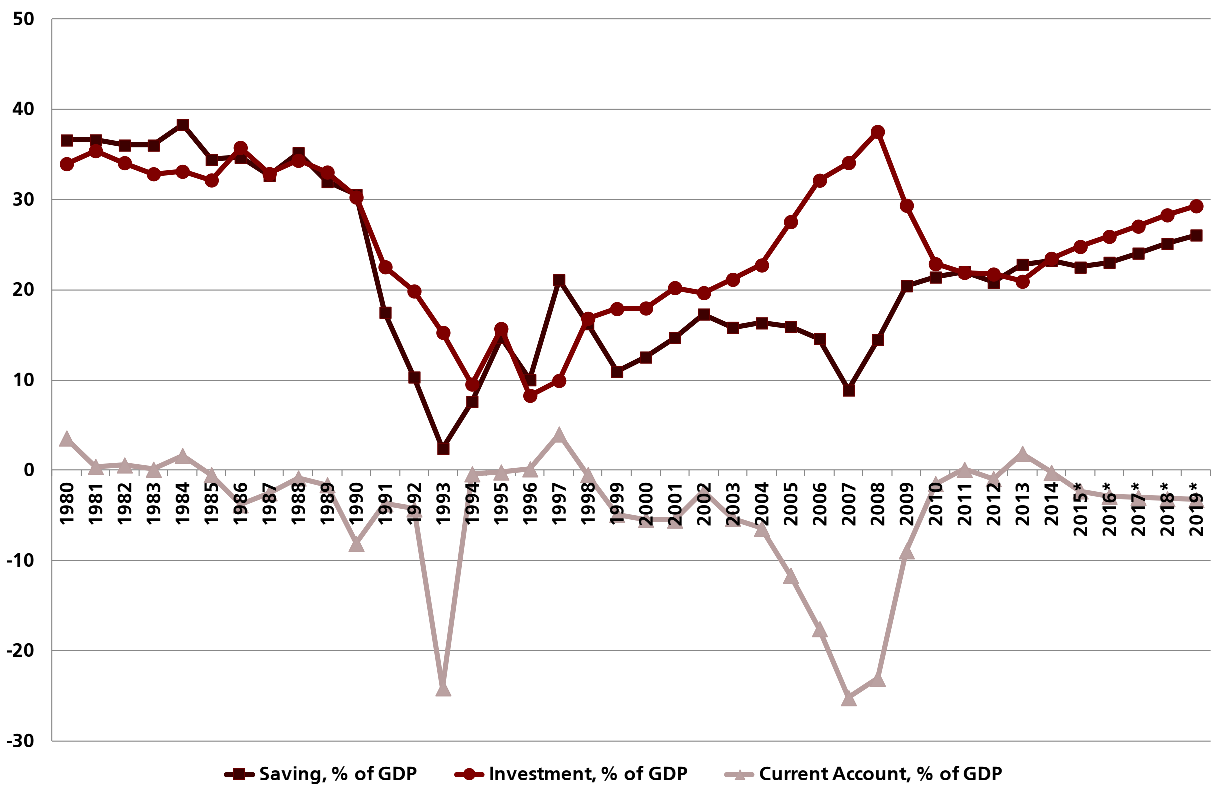
Source: Bulgarian National Bank

Figure 10: Foreign Indebtedness in % of GDP



Source: Bulgarian National Bank

Figure 11: Saving, Investment and Current Account in % of GDP



Source: IMF Database; 2015–2019: projections.

The economic growth process in Bulgaria is marked by an important feature: a declining working population. This means that the main long term source of growth is expected to be capital accumulation plus the total factor productivity.

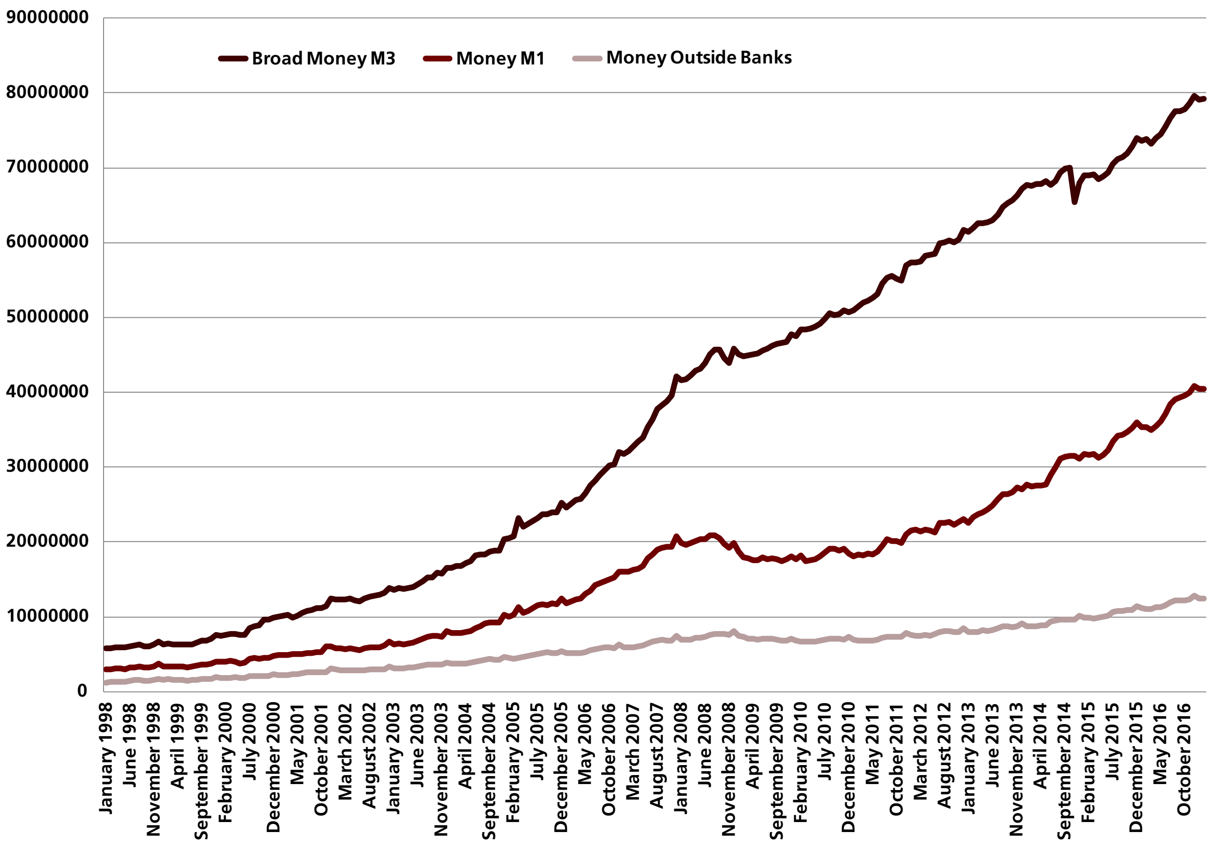
As we can see from Graph 12, after the introduction of the new monetary regime in 1997, the main monetary aggregates broadly increased with, however, notable deceleration after the 2008–2009 crisis. The monetary aggregate M1 was especially vulnerable with significant decline in the period 2008–2011. This can be explained by the withdrawal of foreign short term capital from the country.

In the context of non-existing monetary policy, the interest rates exhibited interesting behaviour, reflecting the self-adjustment of the economy.

To summarise, in the period before the global financial crisis, Bulgaria went through an investment boom driven by strong foreign capital inflow. In the same time the country enjoyed relatively high economic growth, a low level of unemployment and fiscal surpluses. The other side of the coin was the increasing current account deficit and the ballooning domestic credit. The global financial bubble led also to an extreme escalation of all indexes on the Bulgarian stock exchange. Though the internal and external public debt remained low and was even diminishing, private sector indebtedness swiftly amplified. The external liabilities of the banking sector increased especially fast, due to the intra corporate bank deposits, i.e. deposits of transnational banks headquarters with their Bulgarian subsidiaries.

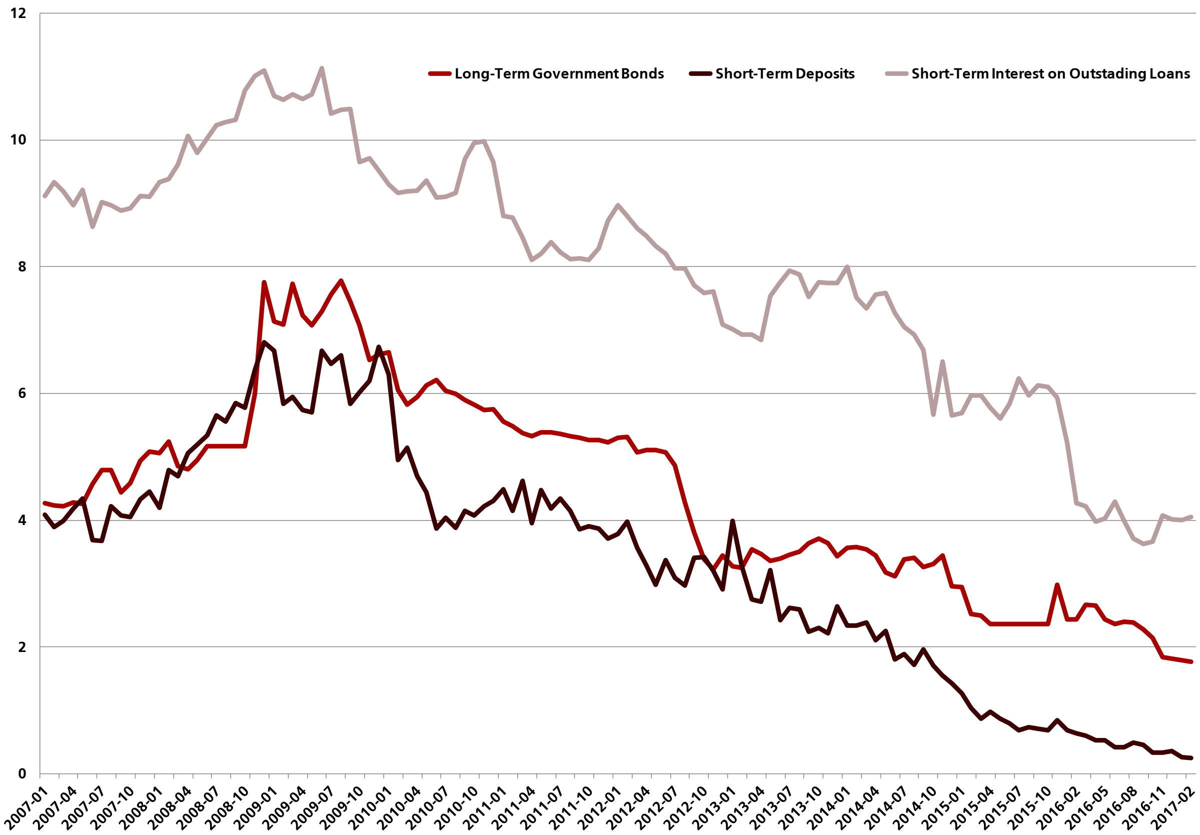
The crisis marks a turning point in terms of FDI decline, improved current account, lower rates of growth, weaker employment and a greater role of the productivity of labour, especially in industry. The growth of exports and the positive shifts in export product structure are gradually becoming an important underlying engine of growth. The deflation episode in the period after 2012 contributed to the slowing dawn of the real appreciation of the Bulgarian currency, but real wages continued to grow. After the crisis the Bulgarian economy became engaged in a process of international deleveraging, affecting mainly the private sector. Domestic credit is stagnating, due to high deposits/loans interest spreads, heavy bad debts accumulation and respective surge of CDS quotes. The net capital inflow via EU structural funds is playing a particularly positive role in keeping growth rates positive.

Figure 12: Money Aggregates (in 1,000 Leva)



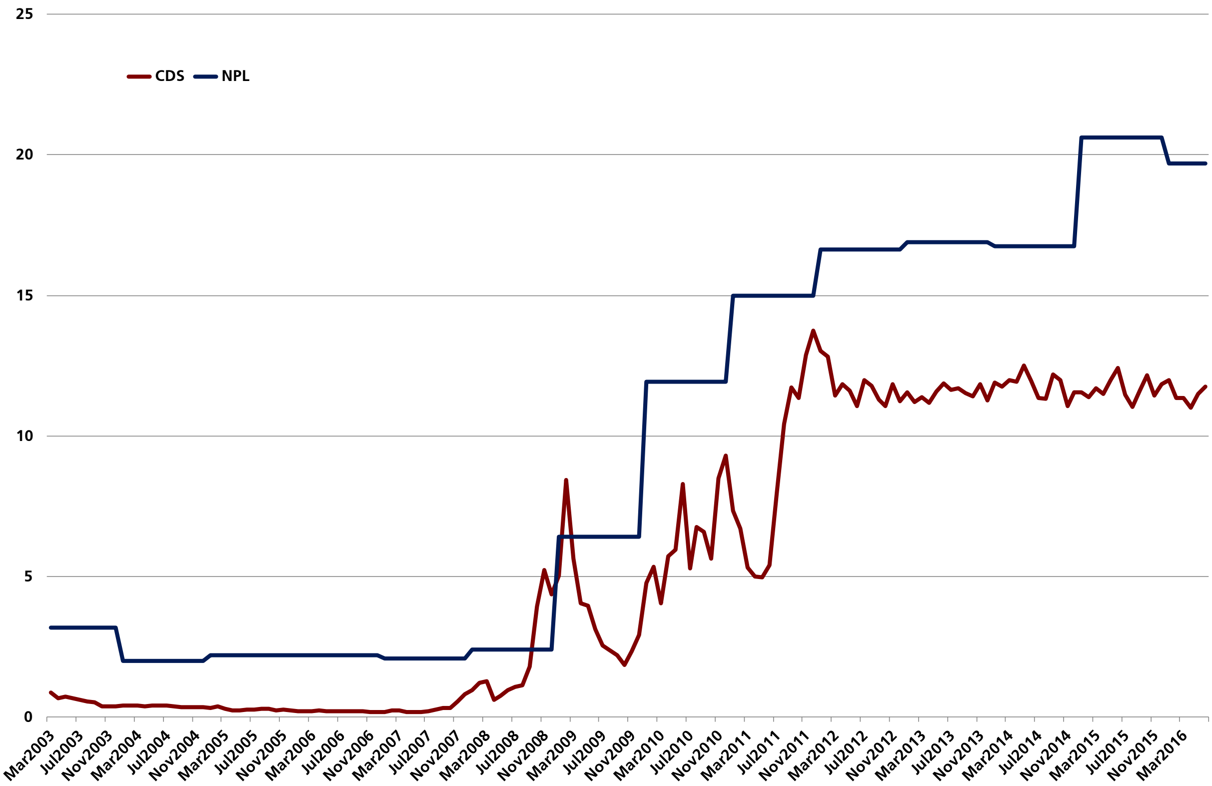
Source: Bulgarian National Bank

Figure 13: Some Interest Rates in Domestic Currency



Source: Bulgarian National Bank

Figure 14: Non-Performing Loans (in % total loans) and CDS Spreads (in % of nominal)



Source: Thomson Reuters and BNB; NPL according to BNB definition

2. Political Economy and Domestic Reform Capacity

2.1 Institutions (Rule of Law, Corruption, Rent-seeking)

According to the IMF's assessment Bulgaria's performance is especially badly in areas concerning the quality of government decisions and actions (Value of Completed Actions) and e-government related topics. Bulgaria's performance is at the average for Southeastern Europe level in the field of central and local administration efficiency, administrative staff working with large taxpayers, fiscal risk assessment, special staff identification and the level of government debt. Bulgaria is among the top performers in terms of the functional structure of government institutions, risk management approach, verification and debt collection and VAT refunds (IMF, November 2016).

The problems with public sector management and performance are the main reason for the continuing supervision under the Co-operation and Verification Mechanism (CVM) with the EU. The issues are: judicial independence and efficiency, integrity and the fight against corruption and organised crime.

The CVM mechanism has been in place for more than ten years (see EC 2017/1). The main conclusion of the EC is that the mechanism turned out to be one of the engines of institutional and judicial reform in Bulgaria, but its progress was interrupted several times by political instability. The recommendations for further reforms include a wide range of proposed actions. These actions represent in fact an international road map for judicial and institutional reforms aimed at imposing the rule of law and fighting against corruption and organised crime.

Together with corruption (Bulgaria ranks a reprehensible 71 among 176 countries according to the Corruption Perception Index 2016, published by Transparency International), the special business interests rent seeking activities represent a serious problem for Bulgaria. The particularity of corruption/rent seeking nexus in Bulgaria is that this type of behaviour is related predominantly to sectors characterised by a monopolistic or oligopolistic market structure (electricity generation and transmission, new electricity sources, water supply, extractive industries, central heating, banking and others), as well as agriculture. These sectors are usually strongly regulated and supervised by the government, which makes the fight against corruption especially difficult.

2.2 Public Sector Efficiency

Any economic growth oriented policy requires the efficient use of public resources. The first question we should answer in this respect is whether the country is able to mobilise a sufficient volume of public funds in order to supply the needed public services. The share of Bulgaria's public expenditure in GDP is lower when compared to the EU average, and Bulgaria, together with Romania and Poland, spends relatively less public funds, compared to the period before the global crisis. It was assumed that, putting a legislative limit on state redistribution, imposing a low level of budget deficit and applying low flat income tax, authorities would guarantee a fast recovery.

In the same time, the low level of public spending does not mean high efficiency (see for details IMF, May 2016). Usually the efficiency of public policies is measured in terms of public investment and tax collection. Bulgaria is among the Eastern European countries with the highest public investment gap when compared with developed market economies (see IMF, November 2016). Bulgaria, together with the other Central and Eastern European countries, is below the efficiency frontier of public investment, i. e. with this level of income per capita these countries could have better public infrastructure. Though rising, the public investment efficiency score of Bulgaria is among the lowest in Eastern Europe, excluding Romania and Bosnia and Herzegovina.

Tax collection is another field for which we have efficiency information for Bulgaria and the other SEE countries. An efficient tax system can be characterized by high tax collection efficiency for a given cost of collection (IMF, November 2016).

The tax collection costs in Bulgaria, as a percentage of GDP, are the highest in the EU. Bulgaria is also among the SEE countries with the greatest level of the shadow economy. The latter is positively correlated with bureaucracy and corruption.

To summarise, Bulgaria is in the worst possible situation, combining the 'under-financing of public services with the low efficiency of public spending. The prevailing opinion among Bulgarian economists and politicians is that we should not increase the share of public spending (and taxation) in GDP before we increase its efficiency. However, it is obvious, that underfunding is one of the reasons for the strong competition for public funds and high level of corruption respectively. So Bulgaria should resolve the problems of efficiency and under-financing simultaneously.

2.3 Macroeconomic Policy

2.3.1 Monetary and Fiscal Policy

Bulgaria has been praised by both the IMF and the European Commission for its relative macroeconomic stability (see IMF, November, 2016/2 and EC, 2016) in terms of low fiscal deficits, government debt and inflation. Since 1997 both fiscal and monetary macroeconomic policies have been dominated by the strong constraints imposed by the currency board rule. The fixed exchange rate and the free movement of capital in the EU exclude by definition any meaningful monetary policy. In addition, the refinancing of the banking sector and the open market operations are strictly forbidden to the Bulgarian National Bank (BNB) by law, so inflationary targeting is technically impossible.

The only remaining instrument of the monetary policy that still remains at BNB disposal are the compulsory reserve requirements. This instrument however turned out to be inefficient and was abandoned. Another curious particularity is the evoked strategy of replacing the monetary policy with an active macro-prudential policy, which is intended to be performed by the BNB in the future (IMF, May 2017).

Fiscal policy remains the only possible tool of macroeconomic regulation in Bulgaria. In addition, the fiscal policy may affect the economy via the monetary channel. The reason for this is the fact, that the fiscal reserves, accumulated at the liabilities side of the currency board balance sheet, directly affect the reserve money supply.

The ability of the government to use fiscal policy for macroeconomic stabilisation depends on two additional factors – the introduced fiscal rules (including the European Semester) and the interplay between the fixed exchange rate regime and the political environment. The fiscal rules generally reproduce the respective Maastricht convergence criteria with an additional constraint that claims the consolidated government spending should not exceed 40 % of GDP. The constraints imposed additionally to the Maastricht requirements strongly reduce the ability of fiscal policy to support growth.

As it concerns the fixed exchange rate-political environment-fiscal policy nexus, the experience of Bulgaria seems to confirm the recent conclusions that, in general, decisions taken under fixed exchange rate regimes are associated with less fiscal discipline (Jalles, Mulas-Granados and Tavares, 2016).

2.3.2 Industrial Policy

In general Bulgaria does not have an explicit government sponsored and targeted industrial policy. The first step in this direction is the Concept for Industry 4.0 approved by the National Economic Council of the Ministry of Economy in the beginning of 2017. It is not an IT program, but a strategy for the digitalisation of Bulgarian industry. The Concept of Industry 4.0, however, is still not financed and does not include a timetable and structured measures.

Nevertheless Bulgaria is applying a broad spectrum of measures and programs, financed predominantly via EU structural funds, which can be categorised as de facto industrial policy.

Another example is the program the "Encouragement of internationalisation of Bulgarian companies" launched in 2010. It included support to a wide range of industries, supposed to be core of the participation of the Bulgarian companies in the international division of labour.

As a whole, Bulgaria needs to prepare and implement a complex industrial policy on the basis of the Concept of Industry 4.0 strategy, supplemented by the necessary administrative measures and financial resources.

2.3.3 Regional Industrial Policy (Regional Networks and Clusters in Specific Sectors, the Connection to Global Value Chains)

The Bulgarian economy is characterised by strong and increasing regional disparities. In addition, the poorest regions in Europe are also in Bulgaria. The regional policy relies on some tax incentives in favour of the poorest regions and on the use of EU structural funds. These measures are not only inefficient, but the use of EU structural funds in particular seems to bolster more the already advanced areas, thus increasing the regional disproportions. The country needs a new regional policy aiming at more even regional development.

In spite of these negative trends, regional networks and clusters are developing with increasing contribution to the positive structural shifts in the industry.

Bulgarian clusters are one of the forms of participation in the global value chains (GVCs). Bulgaria is deeply integrated in GVCs mainly through manufacturing activities (see for details Ivanova N. and Ivanov E., 2017), such as petrol refining, production of basic metals, machinery, electrical and transport equipment.

2.3.4 Structural Reforms (the Efficiency and Regulation of Final Goods and Services, Labour and Financial Markets, and Business Environment)

Government regulation in Bulgaria is centred in areas of energy prices (electricity, central heating and gas supplies), water, some judicial services and public utilities. In addition the authorities supervise the banking sector and financial markets. The government, on the basis of trilateral cooperation, fixes the minimum wage and regulates the labour market. Public procurement is another field of government related activities that strongly affects the investment process and market structure of the economy.

According to the European Commission Country Report Bulgaria 2016, "despite some improvements, the country continues to have one of the weakest results in the EU with regard to government effectiveness and regulatory quality and ranks last for the rule of law and prevention of corruption" (EC, 2016). These findings require from the Bulgarian authorities the implementation of comprehensive and focussed reforms in order to overcome the administrative inefficiency and low regulatory quality. The above mentioned inefficiencies have a strong negative impact on resource allocation and economic growth.

The e-government related measures are at the heart of the much needed administrative reforms. However the EC admitted recently that the reform momentum in e-government has slowed down (EC, 2017/2). This reflects the overall deceleration of the reform progress in Bulgaria.

The banking sector supervision is important, taking into account the strategic objective of the country to join the Banking Union and the Eurozone. The Bulgarian financial system is a bank dominated, control oriented one. The capital market still did not recover from the financial crisis of 2008. Bank lending is in practice the only source of new capital. The insurance sector remains underdeveloped and controlled by a few big companies. The private pension funds linger as one of the few alternatives for saving outside of banks. Yet the government tried to in fact privatise them via the attempt to force people to remove their savings from private pension funds to the state pension fund. If we summarise the data from the World Economic Forum Global Competitiveness Ranking, the Bulgarian financial system is inefficient, but relatively stable.

The labour market, in terms of unemployment, is slowly recovering from the 2008 crisis. In the same time Bulgaria is suffering from the global trend of substitution of labour for capital as a result of the relative decline of the cost of capital (IMF, April 2017). In spite of some official declarations that there is no more unemployment in Bulgaria, the reality is, that excluding some dynamic regions, unemployment at the regional level and especially in rural areas, is a severe drawback.

The business environment in Bulgaria is still negatively affected by corruption habits and heavy administrative burden. However, there are weaknesses related not only to public, but the private sector behaviour. According to the latest assessments of the World Economic Forum the business practices in Bulgaria undergoes serious problems from unwillingness of companies to take risks verve, a lack of appropriate marketing strategies, reliance on primitive competitive advantages (like low labour costs), and an insufficient cluster development, among others.

2.3.5 Employment Policy (Facilitating Employment in the Private Sector and Fighting the Informal Economy)

The employment policy in Bulgaria is based on two types of measures: the Active Labour Market Policy (ALMP) and the Public Employment Service (PES). Both policies are generally considered as inefficient and insufficient.

Undeclared work is viewed by the Bulgarian government as a negative practice, related to the drop in tax revenues, and a restriction on workers' rights to collectively bargain, and access social protection and safe working conditions (National Employment Action Plan, 2016). The measures against the informal economy include the implementation of the Single National Strategy for Increasing the Collectability of Taxes, increasing the regulatory functions of the General Labour Inspectorate, the Employment Agency and the National Social Security Institute and other administrative measures. Nevertheless the share of the informal economy in Bulgaria remains unacceptably high.

2.3.6 Development Policies

Bulgaria remains the poorest EU country with one of highest levels of inequality. The at-risk-of-poverty-or-social-exclusion rate remains above 40 % and is the highest in the EU. Poverty and social exclusion risks are especially high for the Roma population. Poverty remains high and is increasing among elderly residents. Children and youth poverty levels are also high. The main causes engendering poverty are poor education, ethnicity, age, gender and regional concentration.

In spite of the government programs aimed at reducing poverty, the progress is very limited. The main reason is the lack of financing. Bulgaria has one of the least effective social transfer systems in the EU as well as one of the lowest levels of social transfers: the authorities spent just 0.2 % of GDP in 2015 on monthly social benefits and the heating allowances (EC, 2017/2). The reduction of poverty depends also on educational, health care and regional policies. As whole, Bulgaria does not have a consistent development policy aimed at reducing poverty. Such a policy is not compatible with the prevailing taxation and redistribution ratios imposed in Bulgaria.

2.3.7 Investment in Human Capital, Education, R&D and Science

The theory of human capital postulates that, ceteris paribus, education tends to augment skills and productivity and raises workers' lifetime earnings (Miningou and Tapsoba, 2017), so we can expect that education level is positively correlated with income and economic growth.

Both the internal efficiency of the educational system (i. e. its ability to use the education sector inputs to provide education services of a high quality) and the external efficiency (measured as the capacity to produce skilled labour that matches the demand on the labour market) are low. So the government strategy consists of implementing performance-based funding (addressing internal inefficiency) and priority teaching fields such as science, technology, engineering and mathematics (external efficiency oriented).

The problems of this strategy are related to the inadequate measurement of teaching performance and the lack of connection between priority fields and the labour market – even if more engineers are produced, the abnormal difference in remunerations between Bulgaria and the EU will reproduce a scarcity of engineers. Another large concern for the Bulgarian education system is the lack of cooperation between universities and industry. Consequently, Bulgaria still needs to elaborate a consistent educational strategy.

Slow technological advancement and limited innovation performance constrain the growth potential of Bulgaria (EC, 2017/2). Recently R&D spending increased, but is still below the national target and the EU average. Most of the R&D funding is coming from the private sector and foreign companies in particular. Universities R&D funding is the lowest in the EU (EC, 2017/2). As a whole the innovation capacity of the country is poor, according to the Global Competitiveness Ranking.

2.3.8 EU Funds Absorption and Pan-European Investment Programmes

The impact of EU structural and cohesion funds (SCF) on Bulgaria's economic growth is subject to intense discussion (see Paliova and Lybek, 2014). The prevailing opinion is that the SCF influence growth, via potential GDP expansion. It is especially true in the case of infrastructure or human capital oriented projects. In the case of Bulgaria the use of SCF is particularly helpful given the limitations on public expenditure imposed by currency board arrangement and the low taxation and public spending paradigm.

3. Conditions for a Successful and Coherent Growth Policy

3.1 The Post-Communist Competitive Advantage Strategy of Bulgarian Governments

The tacit strategy of virtually all Bulgarian post-communist governments and business circles is based on a very primitive understanding of the competitive advantage of the country, based on low wages and low taxation level as the primary ascendency of the Bulgarian economy vis-à-vis its competitors. As a comparatively poor country, Bulgaria relied also on the relative abundance of labour. The economies of scale factor was completely lost during transition with the disappearance of the big Bulgarian companies in the field of manufacturing, electronics and ICT – Bulgaria was not able to restructure these enterprises or attract strategic foreign investors.

The low labour cost strategy turned out to be counterproductive. The main reason for this is the EU integration and free movement of workers among European countries in particular. The Bulgarian workers simply moved to the better paid jobs in the old EU member countries. Excluding some low value added industries, Bulgaria was not able to take advantage of its labour cost competitiveness.

The low taxation and the low state redistribution strategy (in 2016 the tax revenue as a percentage of GDP is estimated at 29.4 %, among the lowest in EU and still below the pre-crisis level), are also not working. First of all, the truncated personal and corporate taxation does not affect the production costs in the short run. It is true that one can expect better work incentives and more vigorous investment in the future. However these long term advantages are not working yet. In the same time we observe long term disadvantages caused by the low taxation and redistribution. The reason is that the under financing of education, R&D, health, internal and external security, infrastructure and other state-dependent sectors, has a strong, negative impact on competitiveness.

Finally it must be stated, that low wages don not mean automatically competitive unit labour costs. The role of productivity is essential. There are three main factors determining low productivity: technology and investment. The micro level business sophistication and efficiency wage considerations are very important in Bulgaria. So improving productivity is a complex task, including an appropriate income policy.

3.2 Need of Consistent Competitive Advantage Strategy

Though the global competitive ranking of Bulgaria is gradually improving, the position of the country is still not satisfactory. The balance between labour cost and the other parameters of the national competitiveness is not found. The optimal ratio of government spending and taxation in GDP seems to be above the present level. The participation of Bulgaria in the GVC is below the optimal level, so the country is not able to take advantage of the economies of scale in the international division of labour.

3.3 The Role of the EU and the EMU

The role of the EU and EMU in particular is strategically important in several directions. First of all, we should take into account the participation in the common market with the four fundamental freedoms. This imposes a competitive environment not only from the point of view of final and intermediate production prices, but also in terms of aggressive bids for scarce resources, including labour. Though the participation in the common market improves the allocation efficiency of the economy, there are serious adjustment problems.

Bulgaria is not a member of the Eurozone, so it does not participates to the full extent in the EMU. Nevertheless, the comprehensive participation in the EMU, given the particular macro-economic and political situation in the country, can be the decisive first step in overcoming the complex set of obstacles towards more dynamic and inclusive economic growth. In particular, the membership in the Eurozone will allow the country to overcome the constraints of the currency board regime and implement directly the common monetary policy. Such a step would have a positive impact on the banking sector via the reintroduction of the lender of last resort functions and would significantly improve the efficiency of fiscal policy.

3.4 Policy Recommendations

Given the negative demographic trends in Bulgaria, economic growth in the long run depends on the rate and efficiency of investment. Bulgaria needs investments in infrastructure, technology and human capital, both domestic and foreign. The change of the predominantly negative investment climate depends however on the implementation of focused economic policy shifts.

We can distinguish three areas of policy measures that could eventually stabilise and accelerate growth. The first area is the macroeconomic regime and macroeconomic policies. The second is the optimisation of the redistributive functions of the state and the third is related to structural reforms, aiming at improving administrative efficiency, imposing the rule of law and last but not least changing the private business habits in Bulgaria. These three areas are not disconnected, but on the contrary, they are interdependent and the progress in one direction affects the others and vice versa.

The macroeconomic nexus is extremely important in the case of Bulgaria. In terms of macroeconomic policy, Bulgaria, according to some IMF research, can still rely on positive fiscal multipliers (Muir and Weber, 2013), so a stimulating macroeconomic fiscal policy is possible. The relatively low level of government debt is also a positive circumstance. However, this type of policy is applicable only in conjunction with a variant of inflation targeting and a full-fledged monetary policy, which implies the relinquishment of the currency board arrangement via Eurozone accession or transition to autonomous monetary policy.

The second set of measures concerns the redistributive role of the government. The Bulgarian tax system collects fairly small share of GDP as fiscal revenue, but at a very high collection cost. In the same time, the present strategy, based on low taxation and limited redistribution, does not pledge any competitive advantage to the country. Any change of redistributive proportions however requires difficult political decisions.

Up to now the critique of the present taxation and redistributive system has been focused on its justice and equity drawbacks. The emphasis should be switched towards its inability to resolve the economic development problems. The under financing of security, education, health, infrastructure, and R&D undermines the competitive position of the country. In addition, there are serious external factors that would require increased state redistribution in the future, for example a NATO commitment for higher defence spending, EU structural funds reform, a Fiscal Union tax system's coercion and others. Nevertheless, the taxation-redistribution reform will be slow and awkward because it requires a kind of political and social consensus that is hard to attain.

The third area of reforms, concerning the efficiency of the public and private sector is especially difficult to apply. This reform includes also the ability of the government to implement targeted industrial policy and digital strategy in particular. The solution requires strong public society pressure on the ruling elites, combined with an external influence on the part of EU institutions. The progress in the field of macroeconomic regulation will also ease the structural reforms process in both the public and private sector.

In terms of sectoral economic composition, the global economic crisis revealed the lack of competitiveness of the Bulgarian economy, and its dependence on cyclically sensitive economic sectors. The strategy of reliance on foreign direct investment is also under reconsideration. In sectors, such as electricity generation, electricity supply, liquid fuels, finance, retail trade and others, we observe the emergence of monopolistic structures, controlled by foreign entities. In some cases, namely electricity supply and production, foreign companies are in fact subsidised by the state with guaranteed high profits. In the same time corporate taxation is extremely low.

The market imperfections have an especially negative impact on the small and medium size enterprises. They suffer particularly from the high energy prices and expensive bank lending. Retail chains may also obstruct the access of small businesses to markets. All this also requires special government support.

Agriculture was the only sector that really benefited recently from the EU integration. But here also we observe an excessive concentration of funds in specific sectors and a privileged position of big farmers.

To conclude, we can infer that virtually all economic and social problems in Bulgaria can be reduced to two causes – inappropriate government redistribution and regulation, and a questionable belief that unregulated markets, low taxation, fiscal austerity and monetary non-interventionism automatically resolve all problems. Overcoming these obstacles would require however strong and focused efforts. On the whole we can expect that the combined impact of suggested macroeconomic, redistributive and structural measures could accelerate GDP growth rates from the present 3–3,5 per cent per year to about 4,5–5 per cent.

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A Coherent Growth Policy for Croatia

Josip Tica

Executive Summary

- This paper attempts to explain economic developments in Croatia during the last 26 years. In the first part it focuses on the reversals of macroeconomic indicators that were induced by the global financial crises, while in the second part we provide an overview of macroeconomic policy and national reform programs (due to macroeconomic imbalances and excessive deficit procedure).

- The Current economic situation in Croatia is characterized by a high level of domestic and external indebtedness, the potential of a snowball effect in the case of the normalization of ECB monetary policy, a low employment rate and basically zero average growth rates during the transition period.

- Major causes of such below average economic performance can be traced to huge dominance of tourism as the main driver of growth, public investments coupled with high level of euroization (> 80 % of bank liabilities), pro-cyclical fiscal policy and a low level of employability of an elderly work force.

- Major policy recommendations are: (1) to implement active fiscal and labor market policies that can increase the GDP growth rate in the medium run; (2) improve long-run growth outlook of economy with a suitable and implementable set of reforms and (3) improve asset and property management in the public sector.

1. Background

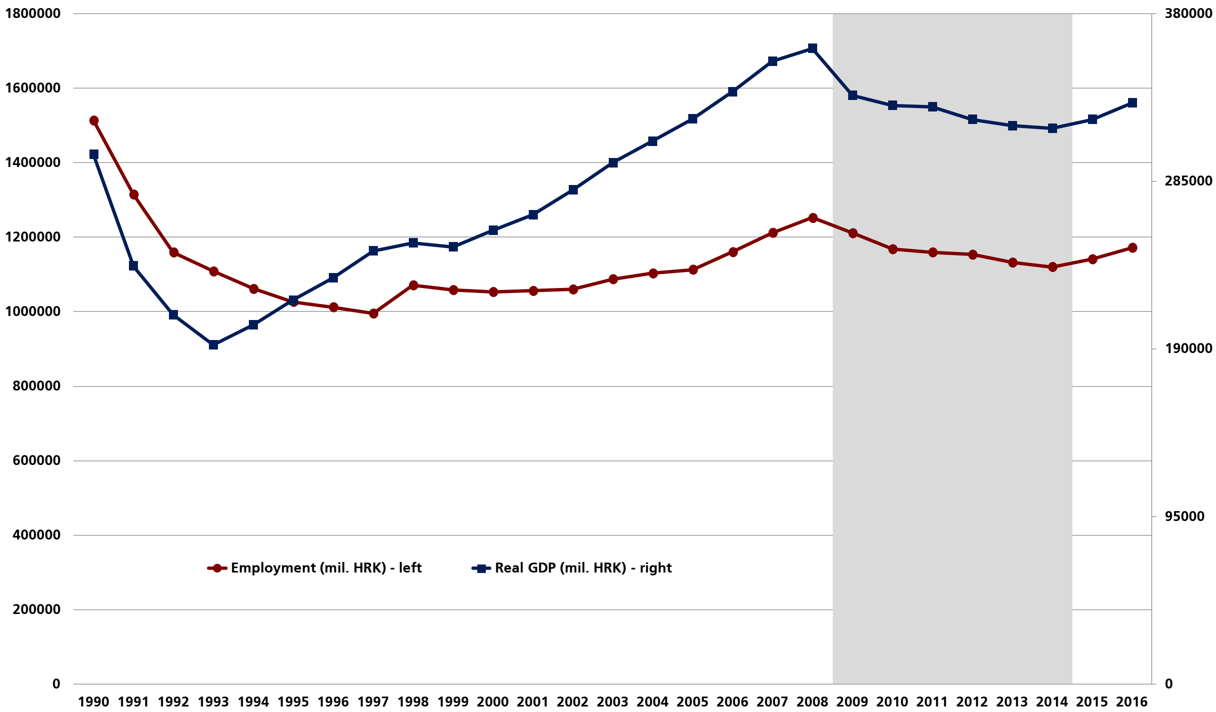
Croatia – as well as the majority of countries in Southeast Europe (SEE) – experienced two distinct narratives with respect to economic growth: an old and a new (post-2008) narrative.

Before the global financial crises (GFC) productivity growth (averaged productivity, not TFP) was a major determinant of GDP growth. During the first decade of 1990, Croatia experienced jobless growth recovery and after 2000 there was a surge in employment, primarily in the construction sector (real estate boom) and the retail sector (credit card financed consumption boom). After GFC, employment dropped down back to its 2002 level.

In general, GDP today is only slightly higher than in 1990, while employment never recovered to pre-transition levels. Today it is 14 % smaller when compared to 1990 although present day methodology includes a much wider definition of employment (along the way police, military, craftsman etc. were included in the employment statistics).

Recovery from GFC started in 4Q14 and since then employment growth has been a major driver of GDP growth. Therefore, our initial premise has been confirmed – productivity has not driven growth in Croatia since 2003 at least. In terms of macroeconomic imbalances (EC 2015), positive movements in employment obviously indicate certain progress in the allocation of resources, but the generators of the recovery are still unknown. The European Commission indicated labor market institutions, policy setting and unfavorable business environment as major drag on the economy (EC 2015).

Figure 1: Productivity vs. employment driven growth



Note: Shaded area depicts the recession, GDP for 1990-1994 was "backcasted" using unchained GDP growth rates, number of employed does not include farm employment, but includes the inclusion of MUP and MORH employees after 1998.Source: Eurostat (2017a) and European Commission (2016a), pp. 78–79.
Source: CBS (2017) and author's calculation.

Throughout most of the transition process, growth in Croatia was financed by foreign savings. Starting with 1995 until 2011 Croatia experienced current account deficits that have resulted in the growth of foreign debt from 17 to 103% of GDP. A current account (CA) reversal happened in 2008. As a consequence of the recession, the import of goods decreased significantly and prolonged the recession, which lasted almost six years (all our major trading partners had much shorter recessions) and resulted in net export growth. At present, Croatia has a deficit in goods trade that is smaller than its surplus in trade in services (primarily tourism and transport), while deficit in net foreign income is covered by surplus in unilateral transfers (secondary income).

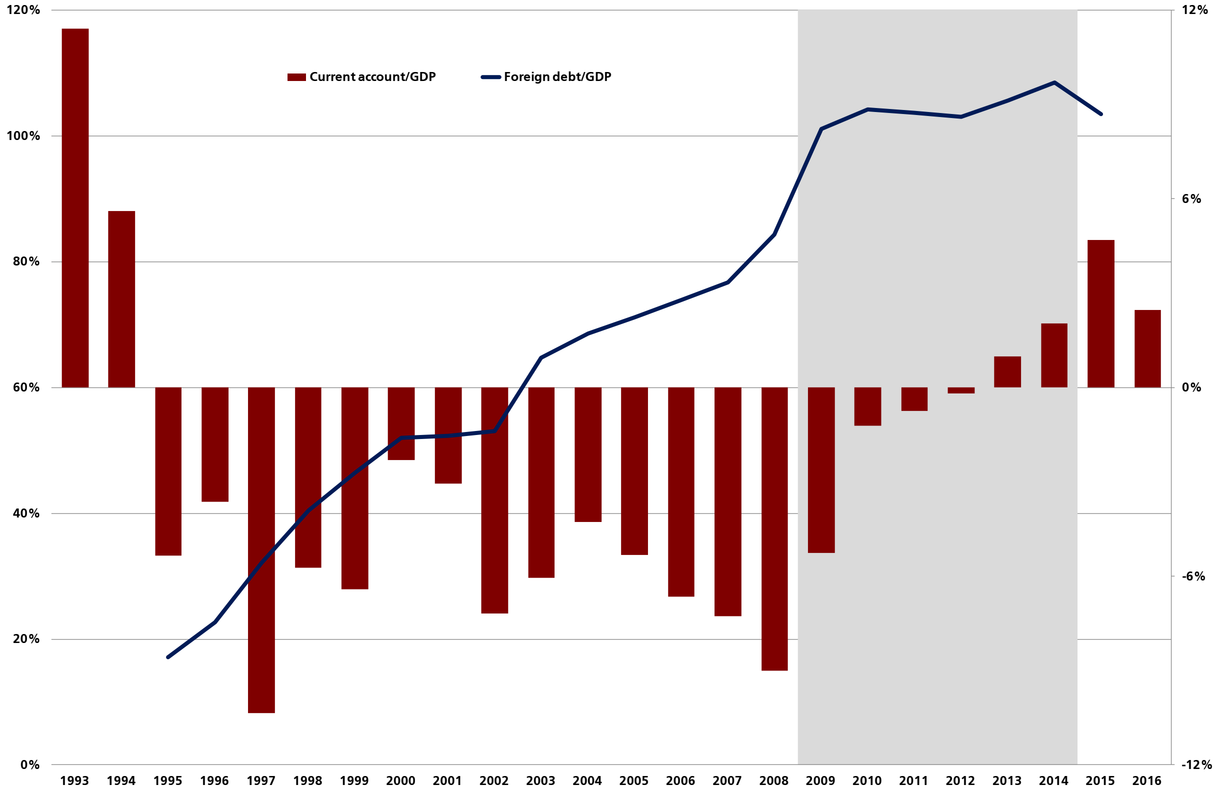
In terms of exchange rate policy we also experienced a reversal, but on a smaller scale. Prior to GFC, the real exchange rate was constantly appreciating since the stabilization program in 1993. Although the appreciation of the real exchange rate was one of the stylized facts of transition reforms, Croatia was slightly peculiar in this way, especially during the first half of the 1990s. The pace of appreciation was smaller compared to other transition countries, but the PPP level of prices was already high in 1990 (even after we take into account the level of development).

After the GFC, the real exchange rate changed its trend and started to depreciate. The Nominal exchange rate depreciated up to 5% and the prolonged six year recession depressed prices and resulted in deflation after 2013 (deflationary pressures were evident even before, but increases in monopoly prices, energy and public companies, resulted in the growth of CPI during the first few years of recession).

In total, both the real exchange rate depreciation and prolonged the recession (a decrease of income relative to trading partners) can explain the current account reversal, but the initial shock came from capital flow reversal.

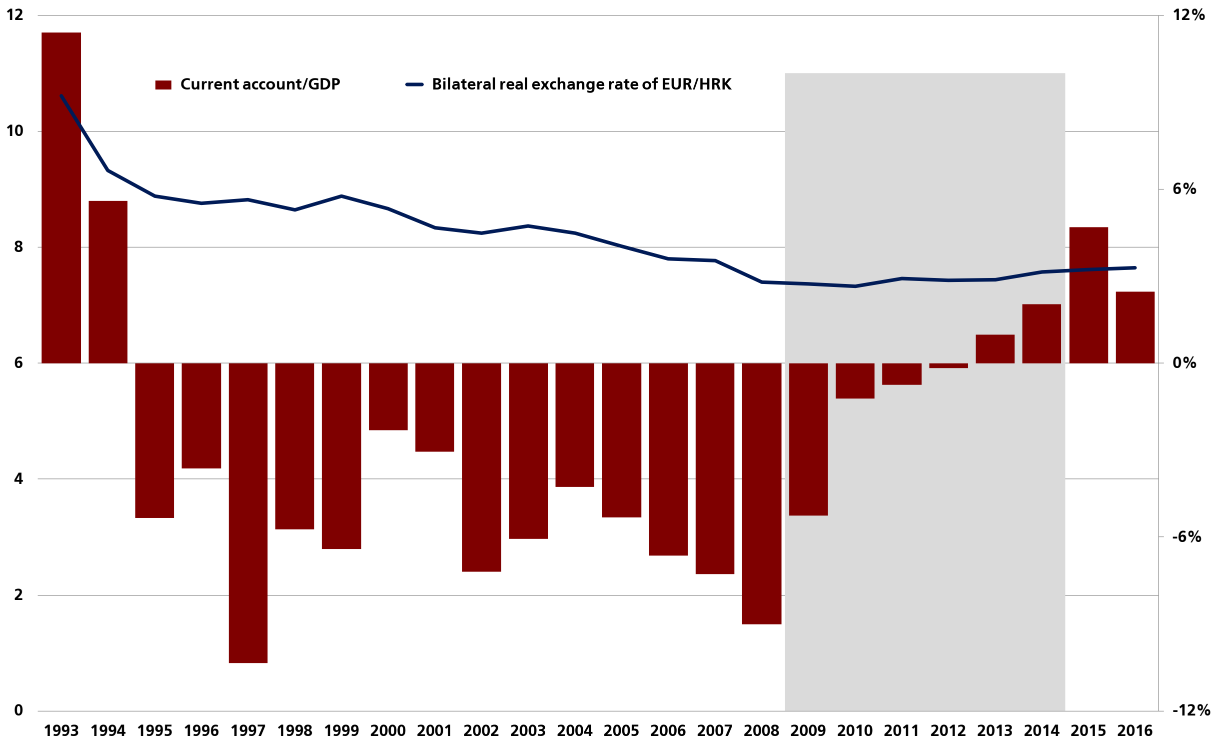
In 2015, weak external competitiveness and a large negative international investment position were highlighted as threats to external sustainability (EC 2015). Since then the current account reversed drastically and the real exchange rate moderately depreciated. Most of the current account reversal was driven by the growth of goods export indicating a serious improvement relative to potential (EC 2015). Nevertheless, as we will see in the section on monetary policy, Croatia is still facing vulnerabilities in terms of outflow of investment income due to its high level of external indebtedness.

Figure 2: Export driven growth vs. increasing current account and trade deficit



Note: Shaded area depicts the recession, current account deficits from the old methodology are used prior to 2000Source: CBS (2017) and author's calculation.
Source: CBS (2017), CNB (2017), CNB (2017a).

Figure 3: Competitive vs. overvalued real exchange rate (RER)



Note: Shaded area depicts the recession, DM nominal exchange rate is used prior to 1999, Croatian retail price index prior to 1999 and Germany CPI throughout the entire period, the increase of the real exchange rate implies real depreciation.
Source: CNB (2017), Bundesbank (2017)

The majority of growth during the 2000–2008 period was financed by capital inflows. Innovation in the finance industry fueled booms in consumer consumption (credit card consumer loans and car loans) and the real estate market (mortgage loans with prolonged repayment periods and single digit interest rates). These booms resulted in an investment boom and bust cycle in retail and housing sections of the real estate market. Having in mind the importance of tourism for growth in Croatia, second home and hotel segments of the real estate market experienced even higher growth rates and proved to be much more resilient to the GFC, primarily due to the nature of demand in that market (and much faster recovery of foreign GDP relative to domestic demand).

After the GFC, capital inflows at first slowed down and then, after the current account reversal, stopped completely in net terms. The private sector started with deleveraging. The growth rate of volume of outstanding mortgage loans has been negative for several years.

The public sector invested huge efforts to decrease the deficit to below 3% before the GFC. Nevertheless, negative effect that the GFC had on budget revenues was mostly financed by public debt and lagged austerity measures. In the aftermath of 2008, public debt increased from 40% to 87% during the recession. Due to higher than expected GDP growth in 2016, public debt decreased moderately to 84%. In 2016, the budget deficit was −0.8% of GDP and Croatia is expected to exit excessive deficit procedure (EDP) during 2017.

The stabilization of the public debt and even a moderate decrease in public debt in 2016 represents a huge improvement relative to the European Commission's statement in 2015 that "rising general government debt is a source of concern" (EC 2015). Nevertheless, there still(as we will see later) is a vulnerability in terms of rising interest expenditure on public debt in the case of a normalization of global monetary policy.

The share of gross capital formation (investment) in GDP decreased strongly in 2009 and remained much lower compared to the 2000-8 period. Obviously, a current account reversal happened due to the decrease in the private as well as the public deficit. Investment decreased from 27% of GDP before the GFC to 21% and stabilized at a lower level. If we compare investment with interest rates, it is obvious that any correlation after the GFC is counterintuitive. In the period after 2008, a major decrease in investments was followed by a major decrease in short term as well as long term interest rates.

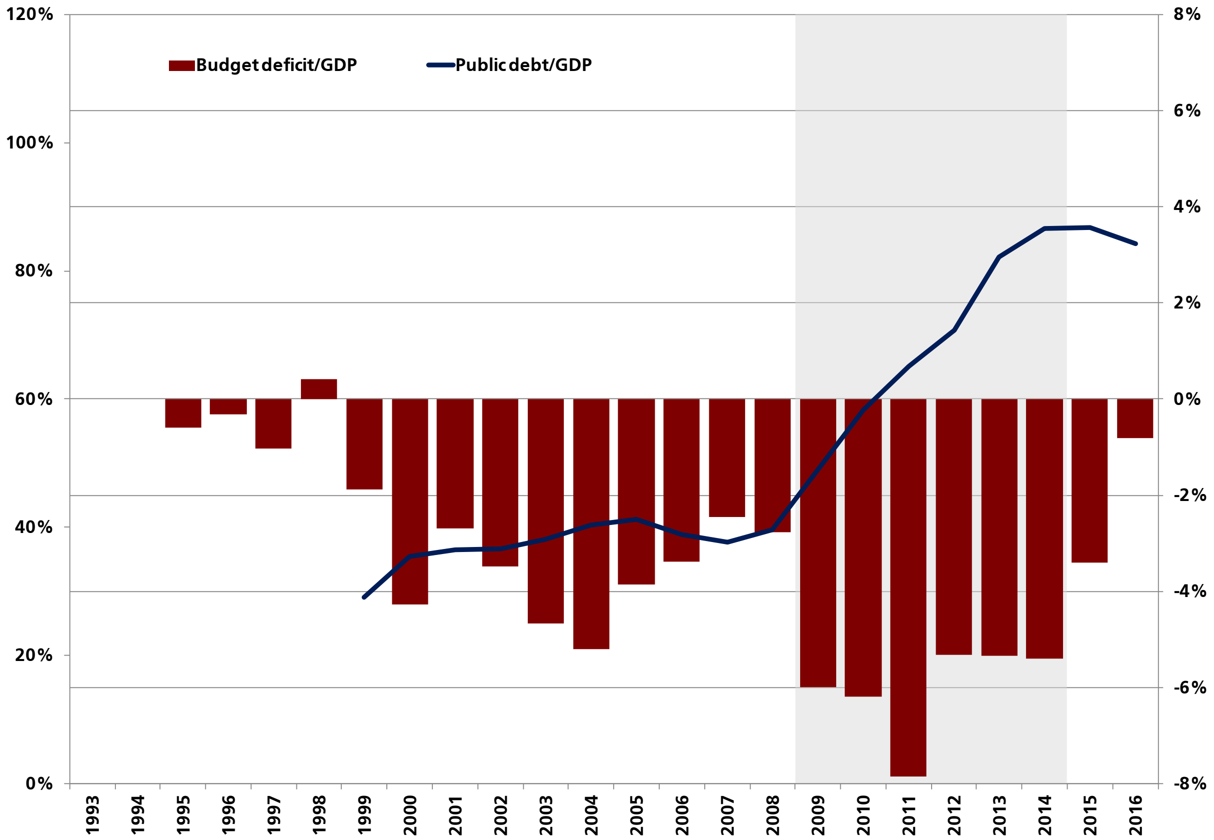
Such a counterintuitive result might be explained with the expectations (animal spirits) and financial frictions literature as well. A correction that occurred on the stock exchange and real estate markets during the crises wiped out a significant part of the net worth of non-financial corporate borrowers. As a consequence corporate eligibility for loans decreased substantially and corporate banks started to hoard cash within the system. Furthermore, the prolonged six year long recession induced quite a pessimistic outlook for the Croatian economy, which has reduced investment activity even more.

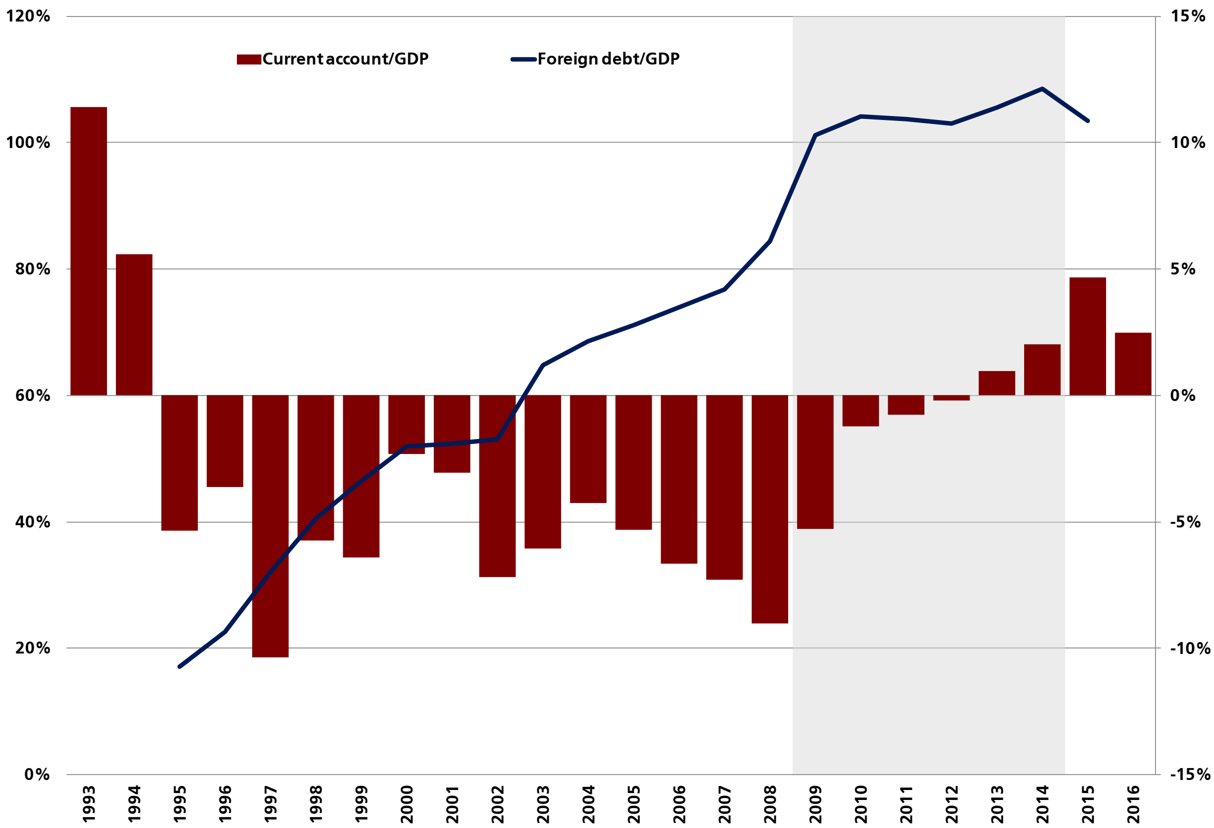
An additional problem is the level of non-performing loans (NPL) in Croatia, which increased from 5 to almost 20% during the crises. In the construction industry it increased to almost 40% in 2015. Such a development within the financial sector added an additional layer of frictions within the financial sector. Up until now, there were not any significant attempts to solve the friction problem with state guarantees (a classical tool in economic theory) due to excessive deficit procedure. Monetary policy was mostly focused on providing additional liquidity to commercial banks and supervising it in order to insure the stability of the financial sector.

In the report on the macroeconomic imbalances, non-performing loans together with indebtedness of households and corporations were identified as major factors holding down consumptions and investments (EC 2015). Deleveraging is still under way and NPLs have started to go down due to a wide range of activities and tax changes that have induced the process together with the general recovery of economy.

When it comes to exchange rate policy, the Croatian National bank (CNB) was very careful in employing it as an instrument of economic policy. During the hyperinflation period (prior to 1993), the nominal exchange rate of the Deutschmark was heavily used as a measure of value and an anchor for inflation expectations. Furthermore, the majority of corporate and households loans in Croatia are denominated in foreign (Euro) currency (more than 80%) which means that major fluctuations in the exchange rate can affect the capability of both sectors to repay loans. It is estimated that 10% of devaluation will increase the amount of indebtedness to 3.6% of GDP (Benetrix, Lane and Shambaugh 2015). Such a high level of indebtedness combined with high foreign currency exposure of the entire economy (even after international reserves are accounted for) creates a peculiar situation for the exchange rate policy. Up until now, CNB has mostly

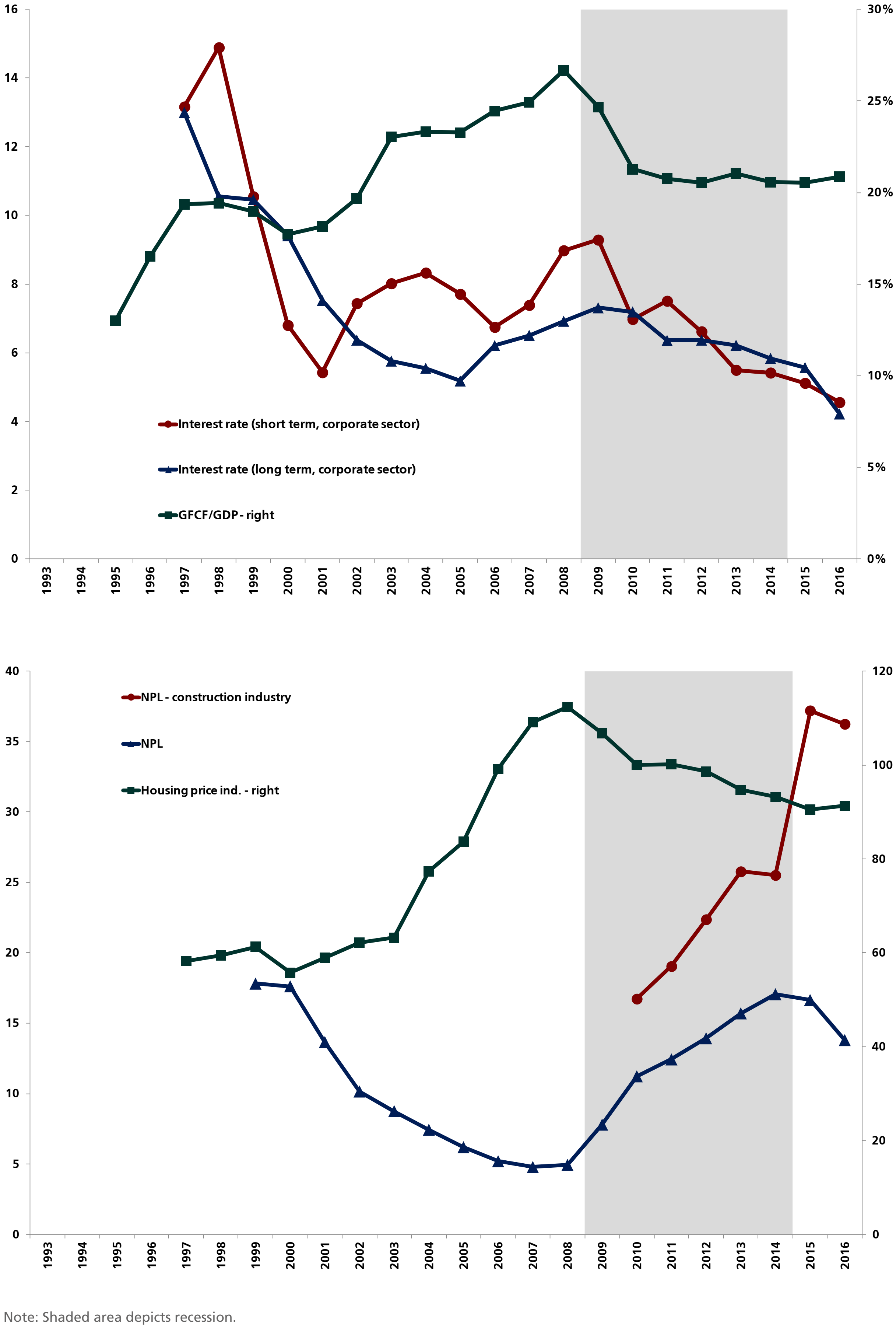
Figure 4: Stable vs. Increasing Private and Public Debts





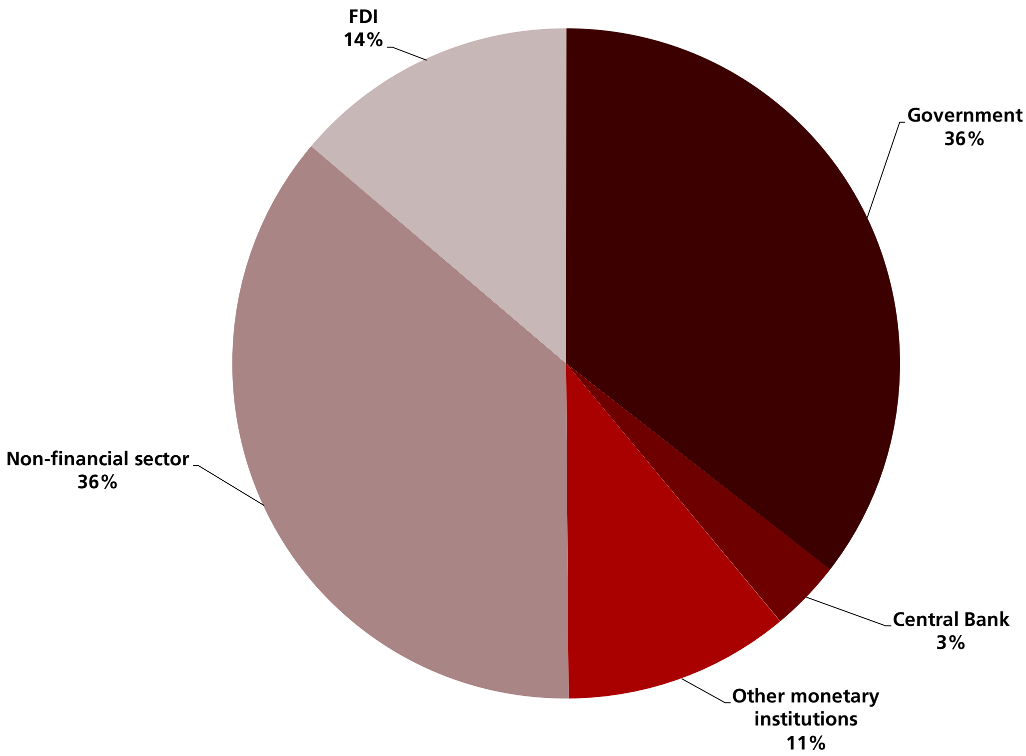
Note: Shaded area depicts recession.
Source: CBS (2017), CNB (2017), CNB (2017a).

Figure 5: Level of Investments and their Financing (Domestic vs. Foreign)



Note: Shaded area depicts recession.
Source: CBS (2017), CNB (2017), CNB (2017a).

Figure 6: Gross external debt structure (2016, in mil. Euros)



Source: CNB (2017), CNB (2017a).

kept the nominal exchange rate of HRK within the 7.2 to 7.9 range in order to avoid balance sheet effects of exchange rate policy.

The problems of foreign exchange exposure are evident in the household sector (mortgage loans denominated in EUR), but also in the corporate sector of the economy. The Corporate sector share (non-financial) of foreign debt is 36% and it is mostly financed by bank loans (the narrative is that "mother" banks of Croatian banks are financing the corporate sector directly). Therefore, in the same way as in the household sector, the corporate sector (with an exception of exporters) is unable to hedge against exchange rate movements.

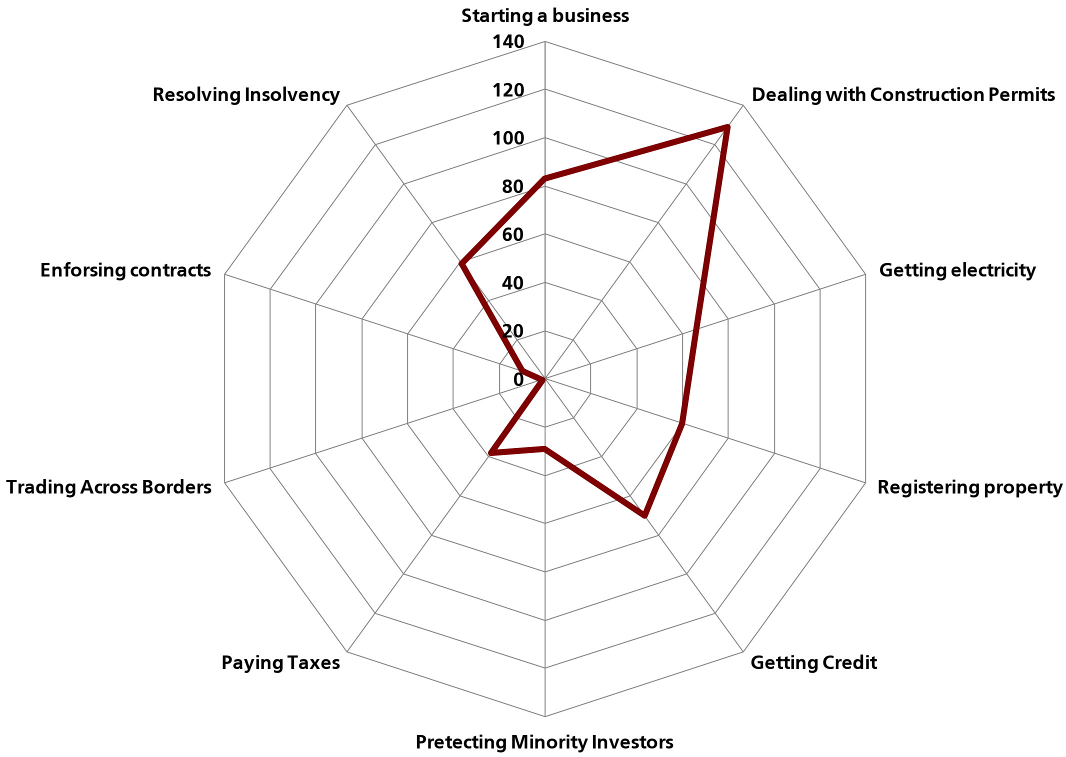
The public sector in Croatia is the least exposed sector in terms of foreign exchange due to the fact that quite a significant part of public debt is domestically owned. The foreign part of public debt represents 36%, while FDI is 14% of the total external debt. In general it is obvious that a huge majority of capital inflows between 1995 and 2012 was financed by bank loans predominantly. The only exception is the government sector where approximately 8 billion euro are financed directly through the capital markets (bonds).

Therefore, in the case of Croatia it is pointless to talk about the failure of the FDI model of financing, having in mind the minor share of FDI in total capital flows, the aftermath of the GFC is much more the failure of the transition model of capital flows in general. In the report on macroeconomic imbalances, the negative investment position has been identified as a threat to external sustainability (EC 2015), but it is important to understand that foreign exchange rate exposure, together with implied valuation effects have been an even stronger obstacle for monetary policy.

2. Political Economy and Domestic Reform Capacity

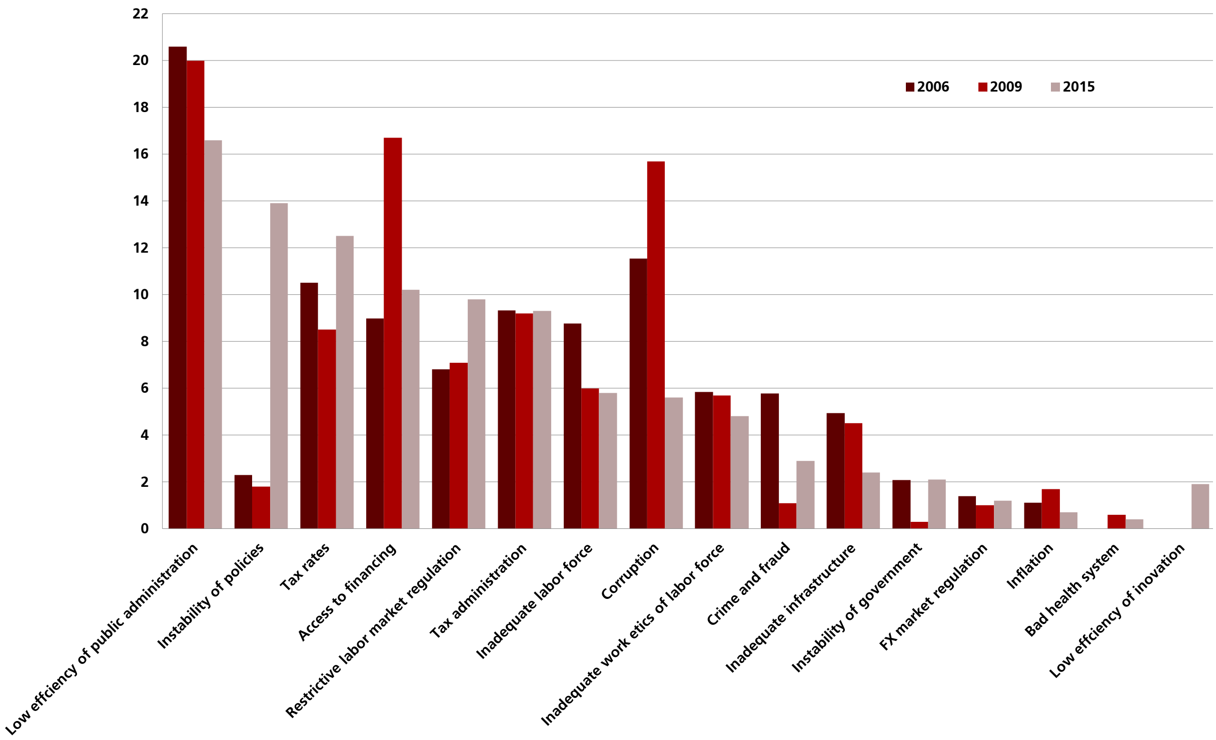
When it comes to political economy and domestic reform capacity, the major challenges are closely connected with the doing business and global competitiveness indicators that traditionally imply several sets of obstacles for economic growth in Croatia. According to the World Forum Survey of domestic entrepreneurs the major obstacles are the low efficiency of public administration and corruption. Secondary problems are access to financing, tax administration, labor market regulation and the instability of policies (especially in the aftermath of the GFC). Furthermore, Doing Business indicators

Figure 7: Rang of Croatia according to Doing Business Indicator (low is good)



Source: WEF (2017), Bogdan and Rogić Dumančić (2016).

Figure 8: The most problematic factors according to perception of domestic entrepreneurs (%)



Source: WB (2015), Bogdan and Rogić Dumančić (2016)

(WB 2015) suggest that major challenges are related to dealing with construction permits, registering property, resolving insolvency, starting a business and getting credit. In all of the mentioned doing business indicators Croatia's rank is 60 or higher which is quite unusual for an EU member state.

Even the European Commission (EC 2015) suggested that Croatia's unfavorable business environment "is a major drag on the adjustment capacity of the economy". Since then, there has been a wide range of policy proposals that have been designed to address the above mentioned issues. According to the National Reform Plan (Vlada 2017) there is a plan to merge the land registry and cadastral books database in order to solve problems with construction permits (cadastral) and registering property (land registry). Also, there is a wide range of activities aimed at improvement of the judiciary system (resolving insolvency, enforcing contracts) such as accelerating court procedures, the improved management of courts, and the strengthening of professionalism, etc.

3. Macroeconomic Policy

3.1 Demand Side Economics

Demand side policies are impossible in the short run in the current framework in Croatia. Monetary policy is disabled by the high foreign currency exposure of the entire economy (household and corporate sector). Depreciation of nominal exchange rate of HRK increases debts of the corporate sector as well as households and decreases consumption (income and wealth effect) as well gross capital formation (collateral effect – financial frictions) resulting in quite an ambiguous net effect on the total economy.

Furthermore, a quite high level of interest rates for short and long term landing to the corporate sector in Croatia (Figure 5) created quite an expensive environment for Croatian companies to finance expansion and growth, which has created numerous problems, especially in the retail sector, agriculture industry and food processing industry (the largest industry in Croatia).[1]

Fiscal policy on the other hand is strongly procyclical. Half of the public debt was accumulated during the recovery from war and transition. During the GFC, public deficits were mostly a consequence of decreased budget revenue due to stalled growth. The Austerity narrative dominated during the six year long recession and total government expenditure mostly stagnated while the share of interest paid on public debt almost doubled.

After it became an EU member, Croatia ended up in excessive deficit procedure which added additional pressures to implement austerity measures and made it less possible to implement demand side macroeconomic policy management. One of the major reasons of such a long recession in Croatia (six years) is definitely the country's inability to use demand side policies. The high level of exchange rate exposure combined with pro-cyclical fiscal policy created a macroeconomic environment in which it is very difficult for policy makers to fight recessions.

The Combination of the inability of economic policy to react and austerity measures during and after the GFC created an environment in which it was not possible to prevent a decrease in credit rating and an increase in the already high borrowing costs of the public, corporate and household sector. In net terms borrowing costs decreased, but primarily due to the ECB's interest rate policy. The Markup over the base rate did not change much. Even in the report on Macroeconomic instability (EC 2015) there is a warning that high and rising interest expenditure might signal the kicking-in of a snow-ball effect.

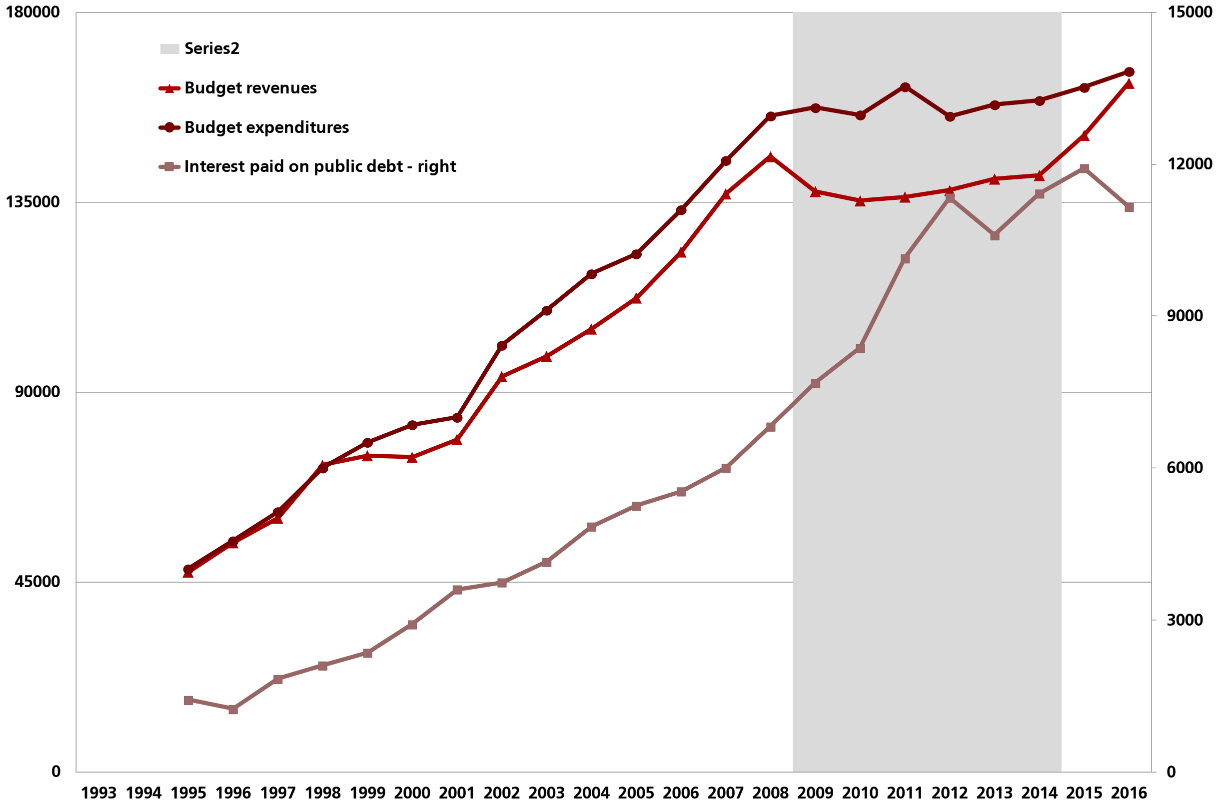
In the situation of inefficient monetary policy, a high level of indebtedness and a high level of currency exposure it is very important to highlight the need of countercyclical fiscal policy. Unfortunately, in the case of Croatia as well as other similar countries in the region, the political willingness to plan and design countercyclical fiscal policy is missing. Usually, fiscal policy is based on a myopic approach to the business cycle and almost always, countries lack any resources to fight recessions. Such a situation is very cumbersome when combine with the business cycle that is idiosyncratic relative to average of the EMU or major members of the EMU (For example: lengthier recessions, higher share of volatile industries, stickier prices, more conservative voters).

3.2 National Reforms Program

In April 2017, the Government accepted a national program of reforms (Vlada 2017). It is a plan in line with the adjustment of Croatian policies with its goals and rules defined by the macroeconomic imbalances (EC 2015) the report and general goals of the EU strategic and development agenda. The most important areas for reforms are: the competitiveness of the economy, employability and education, and public finance sustainability.

1 The problem is most evident in the problems that are facing Agrokor, a company with revenues of 14 % of Croatian GDP.

Figure 9: General budget revenues, expenditures and interest paid on public debt (bill. HRK)



Note: shaded area depicts the recession, ESA methodology only after 2002.
Source: CBS (2017)

3.2.1 Structural Reforms and Business Environment

In order to increase the quality of the business environment, the plan is to coordinate and standardize the work of tax, custom, health, etc. inspections. Also, the plan is to cut the administrative costs for the economy as well as decrease parafiscal levies. Additional efforts will be directed toward the liberalization of service markets such as private education, employment agencies, taxi service, the transport sector, rent-a-cars, real estate management and dealers, tourism, architects, engineers, private health and private foreclosure agencies. Within the doing business narrative, the goal is to increase the number of services provided by e-government service and to enable the establishment of legal entities (companies) online.

Having in mind the chronic problem that Croatia faces in terms of real estate property ownership registration as well as with discrepancies between the cadastral database and the ownership database, the plan is to merge the land registry and cadastral books' database as well as the institutions that are in charge of running these databases (Vlada 2017).

3.2.2 Public Administration

An additional, large problem within the public sector in Croatia is the management of publicly owned assets. In 2013, Croatia started with its implementation of the strategy of management of public assets (companies as well as real estate properties). The goal is to implement an efficient monitoring model for publicly owned companies, and to reevaluate strategic assets and decrease the share of public ownership of non-strategic companies and real estate properties. The management of the publicly owned assets is extremely important if we have in mind that Maastricht rules set limits for liabilities only (and not net liabilities), while the asset part of the public sector is neglected. Croatia has quite a big wealth portfolio, but unfortunately, returns on its assets are quite low due to an unfocused corporate management within the parts of the portfolio or other technical problems (political economy issues, etc.). The goal is to privatize the non-strategic part of the country's portfolio and increase returns on the rest of the portfolio through better management. Additional efforts will be directed toward a higher level of transparency in companies owned by local government.

The plan is to improve human resource management in public administration using new wage determination schemes (performance based), improvements in collective bargaining, an improvement in framework for the fight against corruption, improvements in the accessibility of public administration services, etc.

The National Reform Plan also includes the identification of models of optimal fiscal decentralization and a wide range of reforms aimed at improving the judiciary system (Vlada 2017).

3.2.3 Employment Policies

In 2016, the employment rate of the working age population between 20 and 64 was 63% in Croatia. The employment rate in Croatia is one of the lowest when compared to the rest of the EU. Starting with the 1990s, large parts of the working age population exited the labor force and the problem continues today. Major reasons for such a low rate of employment are early retirement schemes, inadequate nursery (pre-school) availability, an informal economy and undocumented emigration.

In the National Reform Plan increased employability and relevance of education and training curricula to labor market needs is highlighted as a major goal. It consists of plans to: implement programs for active labor market policies (the education of unemployed people), increase the availability and quality of adult education and training, additional efforts are planned to continue with the development of Croatian National Educational Framework, an improvement in relevance vocational training, increases in the importance of internships and practical work at University programs as well as improvements in the monitoring of the quality of higher education. The reform of primary and secondary educational systems with the goal of reforming the curriculum is one of the most important reforms planned within the document (Vlada 2017).

Welfare system reform is mostly based on integration, IT consolidation, the standardization of services and the implementation of a web based system of application. Pension scheme reform is focused on the extension of the work age for the working age population, and fighting against poverty due to small pensions, etc.

Active recruitment policies are also one of the major tools in fighting unemployment issues. Polices were redefined at the end of 2016 with a focus on long term unemployment, young people with inadequate skills and people for whom it is very difficult to find a job.

The conclusions of the evaluation of active recruitment policies were that the measures are efficient, but it is necessary to work on the financial sustainability of the entire system and to simplify the administrative part of the implementation of active recruitment policies. At this point in time Croatia is not investing enough in the active labor policies (Vlada 2017).

An additional challenge for the labor market is the substantial outflow of the working age population that occurred during the GFC which is as high as 200.000 people according to some estimates, and the regional disparity of distribution of the remaining population in Croatia. Especially if we compare the local supply of the work force in the areas that are experiencing economic boom (coastal areas).

Besides emigration, an additional problem for the labor market is the institution of early retirement which is peculiarly used in Croatia. The work force in the age group 55–65 uses early retirement as an alternative tool to lifelong education and active labor policies. These institutional arrangements results in problems with the sustainability of a "pay as you go" pension system and the sustainability of public debt and deficit. With an exception of the first three years of the GFC, a huge majority of the budget deficit (and total public debt) can be explained with the deficit of the "pay as you go" retirement system in Croatia (Figure 10).

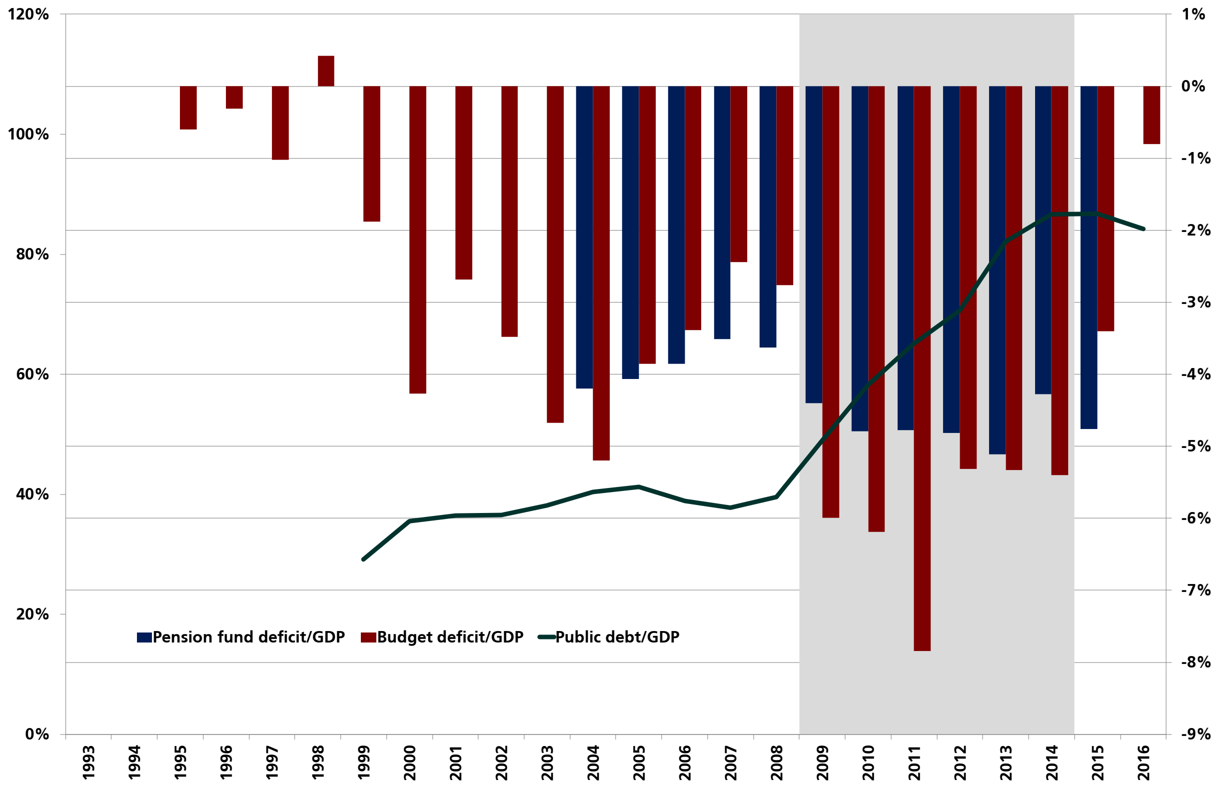
Most of the efforts of the government up until now have been focused on the extension of the retirement age (all persons born after 71 will retire at 67 years of age), while the problem of active labor policies for the 55–65 age group and its implications for employability and the sustainability of the pension fund, have been mostly overlooked until now. Obviously if the goal is to reach EU goals in terms of the employment rate, it is of the outmost importance to create an alternative for unemployed persons in that age group, and to try to delay early retirement and not regular retirement in Croatia.

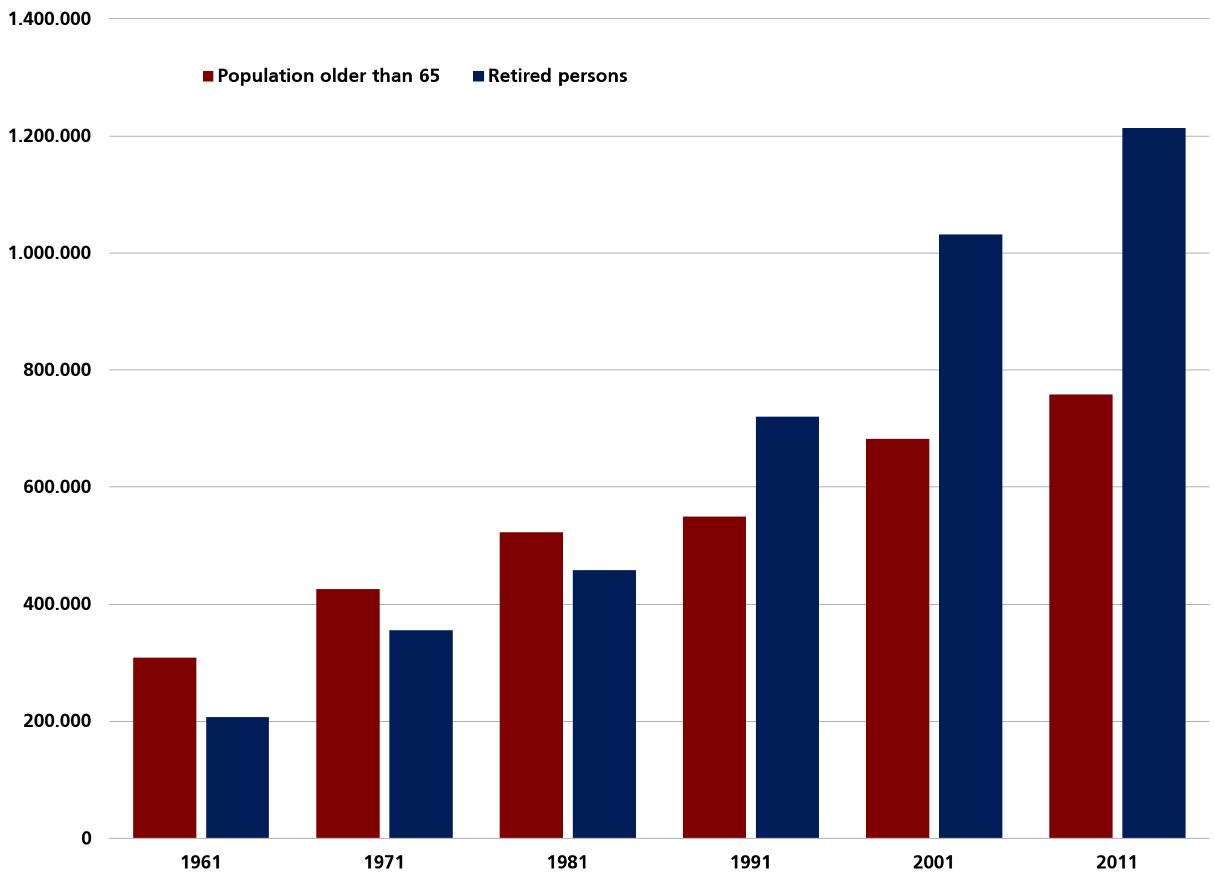
Beside the problems dealing with the sustainability of public finances and the employment rate, pension funds issues are interesting from a political economy perspective. In total, in Croatia there are more than a million retirees and less than 3.4 million adults, making the retirees a major demographic group in the country.

3.2.4 Public Finance Sustainability

The sustainability of public finances is part of the National reform plan (Vlada 2017) and consists of four key elements: strategic planning and develop-

Figure 10: Pension fund deficit vs. budget deficit (left) and population >65y vs no. of retired persons





Note: shaded area depicts the recession, pension fund deficit does not include operating costs of the administrative system, data for retired persons includes non-residents of Croatia (100–150th. depending on the year).
Source: CBS (2017), CPII (2017), Tica (2014), Akrap (2006).

ment, debt relief and the sustainability of the health system, the improvement of the welfare system and the sustainability of the social security system ("pay as you go" – pension system).

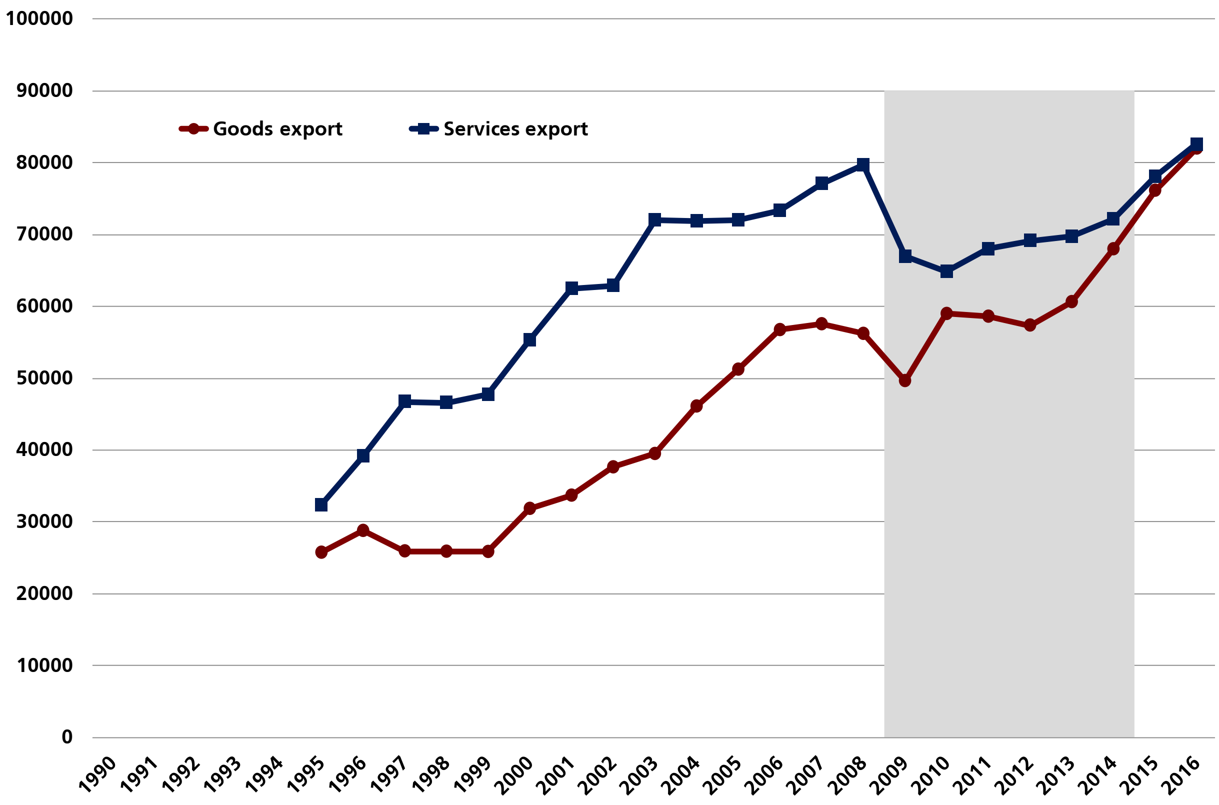
The strategic planning and development part is focused on the development of the link between strategic documents and budget positions together with an evaluation criteria and methodology. The second part is the improvement of the fiscal framework based on the implementation of the Stability and Growth pact. The third element is public debt management. The last part includes the implementation of recommendations of the state audit, further improvements on the joint public procurement procedure, and the improvement and simplification of the procedures related to ESIF operative programs.

The health system reform package focuses on debt relief (by the government) in the health system and the sustainability of the health system in general. The health package has several parts. The first part is focused on the integration of hospitals in Croatia. The second part aims at the efficiency and quality of health services using investments in daily hospitals and the promotion of the daily hospitals network in Croatia, the rationalization of costs and revenue optimization. The third part focuses on the development and implementation of human resource policies in the health sector. The fourth part is a joint procurement, the control of medication consumption and the computerization of the system. At the end of the program, the focus is on the popularization of a complementary health insurance system (Vlada 2017).

4. Conditions for Successful and Coherent Growth Policy

It is a popular narrative that competitive advantage of Croatia is its export of services, namely the tourism sector and the intermodal transport sector that connects Croatian ports with major EU transport corridors. Nevertheless, after the GFC, the growth of goods exports proved to be much more resilient to recession among the country's main trading partners (Germany, Italy, Austria and Slovenia) and it started to grow much faster after Croatia joined EU in 2013. Throughout most of the period, export of services had bigger share in total exports, but goods exports are slowly becoming more dominant, primarily due to EU membership.

Figure 11: Export of goods and services (in 2010 prices)



Note: shaded area depicts recession.
Source: DZS (2017)

Within the goods export, the share of manufacturing is 87 %. Within the manufacturing section, the three most dominant export divisions are the oil industry (C19), the manufacturing of machinery and equipment (C28) and the manufacturing of food products (C10) totaling approximately 9–10 % of total export of goods in Croatia. In the second group of exporting divisions are: the manufacturing of electrical equipment (C27), the manufacturing of fabricated metal products, except machinery and equipment (C25) and the manufacturing of chemicals and chemical products (C20) with shares between 7–8 % of total exports of goods in Croatia. Unfortunately, although the share of manufacturing is 87 % of goods exported, the share of tge manufacturing sector in gross added value in the overall economy is 14 % (Kovačević, Beg and Sekur 2016).

Within the export of services, traveling (business and private) has a share of 93 %, while all other sectors have shares that are less than 5 %. Unfortunately, in the NACE classification it is not possible to identify the tourism sector, so it is very difficult to estimate the added value of that sector, but there is an expectation that the tourism sector has much higher productivity and added value compared to manufacturing sector (Družić and Andabaka 2016).

We can only analyze the total factor productivity and average productivity in transporting and storage (H), accommodation and food service activities (I) and real estate activities (L). According to the statistical data, the main outlier is "L" with the highest average of productivity in the entire economy. Three times higher compared to the second best: Mining and quarrying (B) (Gelo and Družić).

When it comes to international indicators of competitiveness such as the Doing Business and Global Competitiveness Index we can group problems into two major groups: (i) internal related problem of the economy and (ii) external related problems. Internal problems are closely connected with the domestic judiciary system, especially when it comes to solvency problems and issues with registering property; or with the efficiency of public administration when it comes to problems with starting a business and/or obtaining construction permits. A similar conclusion can be drawn from the GCI survey that indicates issues with the efficiency of public administration and corruption in general. The second group of problems is related to the "access to financing" (especially after the GFC) and "getting a credit" category in Doing business database.

5. The Role of the EU and the EMU that Complement Domestic Reforms

The most important role of the EU should be to provide a framework and experience, as well as financing (Through OP) for various programs that can address the identified issues that represent challenges for the Croatian economy. The most important problem is to address the issue of employment through active employment policies and increased funding and sustainable financial construction that can result with increases in the employability of pre-retirement age groups. In order to increase employability, we need to improve the education system (lifelong learning as well as the classical education system.)

In order to create jobs it is necessary to create a strategy that will remove obstacles and provide additional incentives to invest in higher added value activities in manufacturing, transportation and tourism sectors, as well as the rest of the economy. This goal is also complementary with EU strategies, as well as environmental incentives in regard to a more efficient use of energy (especially in real estate sector) as well as an orientation towards renewable sources of energy.

The last part is definitely the transportation sector and the geo-strategic role that Croatia has in the creation of the EU's transport corridors.

When it comes to the EMU, the major vulnerability of Croatia is the potential of a public debt snow-ball effect in the scenario of the normalization of monetary policy in Europe. In the *ceterus paribus* analysis a return of the ECB to pre-GFC interest rates could increase the share of interest on public debt in total expenditure of general government from 7 to even 15 % in the medium run. Implied austerity measures or a snow-ball effect in public debt would hinder any optimistic prospect of growth in the medium run in Croatia.

Having in mind the total lack of willingness of policy makers to engage in countercyclical fiscal policy and low (or non-existing) efficiency of monetary policy in Croatia (and region in general), it might be interesting to devise a countercyclical mechanism within the ESIF. The countercyclical behavior of investments, as well as the countercyclical dynamics of the contributions of member states might be used as an interesting innovative tool to smooth out business cycles in countries in need (not only Croatia).

With a properly devised countercyclical movement of investments and contributions paid by member states it might be possible to make recessions shorter and milder as well as to decrease the need for pro-cyclical austerity measures (together with all intra and international political burdens/conflicts attached to it) while controlling the level of public debt relative to potential (cyclically adjusted) GDP at the same time.

6. Policy Recommendations

Having in mind Croatia's peculiar monetary environment and peculiar fiscal position, it is of the outmost importance to prepare the Croatian economy for the normalization of global monetary policy. In order to do this it is important to focus on: (a) measures that can stimulate growth in the short to medium run (labor and fiscal policies) in order to grow out of the high debt to GDP ratio before normalization; (b) improve the medium to long run outlook of the economy with a suitable and implementable set of reforms that can lower the risk premium prior to the normalization of the monetary policy; (c) achieve higher returns on publicly owned assets and decrease net indebtedness through improved asset and property management in the public sector.

Due to the peculiarity of monetary policy in the environment of high foreign currency exposure and the high level of indebtedness it is necessary to have in mind a much broader number of instruments of economic policy. Having in mind the developments in exports of goods and services it is of the outmost importance to focus on the international competitiveness of exporters. Tourism, agriculture and manufacturing exporters should be of the outmost importance in future export oriented policy design.

In terms of household and corporate over indebtedness, it is necessary to develop short terms instruments that can decrease the negative effects of indebtedness on the demand for investment goods and investment activity in general.

Industrial policy should be focused on alleviating obstacles to endogenous growth in the manufacturing, agriculture and tourism sectors in the short to medium run, but also focus on the improvements in education and research activities that can create an inductive environment for the improvements in the complexity of the goods and services produced. Compared to other non-Mediterranean transition countries, due to the strong growth in tourism and real estate sector, most of the manufacturing in Croatia was neglected in terms of investments and restructuring. Relative returns in manufacturing prior to the GFC simply were not attractive enough relative to the real estate, tourism and infrastructure (highways) business.

It is extremely important to invest resources in an active labor market policy, a life-long learning and education system in general in order to prolong the employability of the average worker. Having in mind the age structure of retirees, a long term strategy of handling this problem is definitely required in order to alleviate problems with implicit public debt, a low employment rate and growth rate in general. In terms of the per capita GDP gap relative to the European core, the employment rate might be one of the major drivers of underdevelopment.

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A Coherent Growth Policy for Serbia

Jurij Bajec

Executive Summary

- Export led growth, relying on EU and a more intensive regional integration is the most acceptable option for the dynamic and sustainable economic development of Serbia.

- A higher share of investments in GDP with higher value added can increase the employment of Serbia's qualified labour force and ensure decent wages; higher investments in education and human capital can aid the workforce's response to dynamic changes on the labor market and ongoing technological changes.

- The main challenges of implementing a coherent growth policy are:

  – Increasing national competitiveness and higher efficiency of institutions, provided there is a political will, professional governance of the state and independent judiciary;

  – Undergoing a comprehensive reform of the public sector for the purpose of more efficient and better quality public services;

  – Implementing a stabilizing fiscal and monetary policy;

  – Implementing a social policy that will reduce high poverty risks and income inequality.

1. Characteristics of Pre-Crisis and Post-Crisis Economic Growth

1.1 The Late Start of the Transition Process and an Economic Growth Based on Imports and Spending

Unlike other countries, Serbia began its transition to a modern market economy and European integration process, for known reasons, a decade later than the rest of the region, in 2001. Another issue was a very low material base as a result of international sanctions, wars, and the break-up of the ex-Yugoslav market during the 1990s. In the period 1991–2000, Serbia lost around 150 billion euro of potential GDP. Thirdly, the then Government was faced with great expectations from the citizens for a fast improvement of the standard of living. In 2000, GDP per capita was around 1,600 euro and the monthly salary was around 50 euro (Serbian Post-Crisis Economic Growth and Development Model 2011–2020, p. 6).

In the period 2001–2008, a solid average annual GDP growth rate of 5.4 % was achieved. However, this growth was based on increased consumption and imports of consumable goods, financed by revenue from privatizations and private borrowing abroad. The annual growth of domestic demand (7.5 %) and spending (7.3 %) was much faster than the annual GDP growth rate. The faster growth of imports over exports led in 2008 to a foreign trade deficit of 26.3 % of GDP and a current balance of payments deficit of as much as 21.1 % of GDP. The share of tradable goods sectors in forming GDP dropped from 32 % to 24 % in 2008 with a fast increase in the share of services and non-tradable goods (Serbian Post-Crisis Economic Growth and Development Model 2011–2020, ibid).

The accelerated process of privatization (Uvalić, 2010) led to the deindustrialization of the country and the growth of unemployment due to the lack of investments in building new industries or modernizing the country's existing capacities. The Domestic private sector was weak, financing its activities primarily through loans and borrowing abroad. FDI through privatization went primarily to taking over local banks, real estate and commerce, as well as profitable "monopolistic" enterprises (tobacco, cement). Greenfield investments into the production of export competitive goods were almost non-existent. As were the investments into infrastructure projects.

Toward the end of 2008, with the start of the negative effects of the global economic crisis, Serbia faced its own internal crisis because it created two fundamental macroeconomic imbalances: the faster growth of spending than the growth of GDP with an increasing foreign trade and current balance of payments deficits; and a defective economic structure with a declining share of tradable goods sector and the growth of an unproductive service sector. Even without the global economic crisis in 2008, the continuance of this type of growth model would have no longer been possible.

1.2 Two Phases of Post-Crisis Economic Growth

1.2.1 Effects of Global Economic Crisis, Inconsistent Macroeconomic Policy and Slow Implementation of Reforms (2009–2014)

Serbia felt the biggest hit of the global economic crisis in 2009. The crisis directly affected the country's economy. GDP in 2009 decreased by 3.1% and the unemployment rate increased from 13.1% to 16.1%. Imports dropped by 30.4 %. Due to the decline of public revenue, the fiscal deficit almost doubled and increased to 4.4 % of GDP.

The main dilemma for economic policymakers (Cvetković, 2012, p. 71) was whether in a crisis condition, the Government should implement austerity measures or an expansive fiscal policy and thus stimulate economic activity and preserve the living standard of the citizens. The policy of increasing the fiscal deficit was chosen, which led to an accelerated growth of public debt. The reason for the poor situation in the budget was the further financing of losses and activating guarantees for loans to public enterprises, the continuation of subsidies for state-owned enterprises and the abandonment of serious reforms of the public sector.

The 2012 elections brought to power a new political option, which proclaimed a liberal concept of economic policies. However, in the next two years (2012–2014), the macroeconomic policy did not change significantly nor was economic growth achieved in that period. First of all, the attempts of fiscal consolidation (decrease of salaries and pensions in real terms and an increase in tax rates) did not yield any results, because the "savings" achieved were all spent on covering the losses of unreformed public enterprises, non-privatized state owned enterprises (SOEs), and the liquidation state-owned banks. At the same time, there was a decline of tax revenues due to tax evasion and the growth of the grey economy. As a result, in addition to the GDP's decline by 1.8 % at the end of 2014 (partly due to large floods when industrial production declined by 7.9 %), the fiscal deficit grew to 6.6 % of GDP and the public debt climbed to 72 % of GDP.

In the period 2009–2014, Serbia went through three recessions which were also affected by external factors. Still, the main issues were of an internal nature due to inconsistent macroeconomic policies and the abandonment of necessary but politically unpopular reforms. That is the only way to explain why after six years, Serbia's economy was in a dead lock again. GDP in 2008 was 33.7 billion euro, and in 2014 it was 33.3 billion euro, the unemployment rate increased from 13.6 % to 19.2 %, while salaries and pensions decreased in real terms. At the same time, the fiscal deficit and public debt reached a record high.

1.2.2 Three-year Stabilization Program with IMF (2014–2017)

Faced with a new decline of GDP, the fast growth of the fiscal deficit and a dramatic increase of interest payment on public debt (from 2.9 % of overall public expenditures in 2011 to 6.1 % in 2014) with a real danger of a new public debt crisis, in the autumn of 2014, the Government agreed on a strict three-year stabilization arrangement with IMF with three basic goals (IMF, 23 Feb 2015):

First, strong mix of fiscal consolidation and a rebalancing of policy. This was supposed to ensure a fast lowering of fiscal deficit and curtailing the growth of public debt through reducing pensions and public sector salaries, rationalizing the number of employees in the public sector and public enterprises, and reducing the state aid to state-owned enterprises. This would create a space for a more relaxed monetary policy, which would stimulate crediting for the business sector, and would increase economic activity.

Second, strengthening the financial sector. This refers mostly to the stability and resilience of the banking sector. The task of the Central Bank is to design and implement a strategy of reducing non-performing loans (NPL) and to affect a larger "dinarization" of the economy.

Third, boosting competitiveness and growth. The Focus is on structural reforms and the main priority is creating jobs, improving the business environment and competitiveness and, finally, resolving the problems of SOEs.

After two and a half years the main goal of the program has been achieved. The fiscal deficit of 6.6 % in 2014 has been eliminated and by the end of 2017 a surplus of 0.5 % GDP is expected (Fiscal Council, September 2017). The growth of public debt has decreased from 74 % to 68 % GDP (partly because of the strengthening of the dinar to the dollar in 2017). Second, the Central Bank has reduced the restrictiveness of monetary policy, primarily by reducing the reference interest rate (from 11.5 % in 2012 to 4 % in 2017). NPLs have dropped below 20 %. The "dinarization" of deposits has moderately increased to 30 %, compared to 12 % in 2012. Third, economic growth of 0.8 % and 2.8 % was achieved in 2015 and 2016, respectively, and according to official forecasts, it will increase 2.3 % in 2017, which is still the lowest in the region (except Macedonia).

Investments and exports are the main drivers of growth. The share of exports of goods and services has doubled (from 26.8 % in 2009 to 53 % of GDP in 2016). The current account deficit decreased from 11.6 % in 2012 to 4 % GDP in 2016. Unemployment, although still high, particularly among young people, was reduced to 13.2 % in 2017 (LFS). New laws have been passed, which had a positive effect on increasing in economic and investment activity (Labour Law, Law on Planning and Construction).

The main question is whether the results of this program, achieved so far, are a good basis for future sustainable export led growth? Have adequate institutional requirements been set up and appropriate macroeconomic and development policies defined?

2. The Main Limitations and Key Challenges of Implementing Coherent Growth Policy

2.1 Political Economy Issues

2.1.1 Institutions

On the competitiveness list of 140–145 countries, Serbia has been ranked between 85th and 95th place for years, which is lower than most of the countries in the region (WEF, Competitiveness Reports, 2007–2016). Although its general position has improved in the latest report (September 2017), where Serbia is ranked 78th out of 137 countries, especially worrying are indicators that measure the importance of institutions: property rights (124), judicial independence (118), burden of government regulations (122), and efficiency of legal framework in settling disputes (117).

Obviously, Serbia still has not overcome the "transition shock", it is still in a sort of institutional vacuum, and the value system of the previous regime is still present (Madžar, p. 210). The absence of comprehensive and efficient institutional framework and lack of strict adherence to the adopted rules, has led to short-term ad hoc measures of economic policy and constant interventions in the economy, affecting rational decision making and voluntarism. It is not the market that forms institutions, rather it is the state that has to establish an efficient institutional framework in which a functional market economy can operate.

There are two issues here that need to be overcome. One is the existence of a political will for the efficient functioning of institutions, for a fully independent judiciary to become the top political priority, and the other is consistent work on a higher professional capacity of public administration. Progress in these areas have a large impact on sustainable economic growth. The government is constantly being warned of these issues in the opening of different chapters in the EU accession process and in numerous reports from international economic and financial organisations. For example, the EBRD report ("Stuck in Transition", 2014) insists on building political institutions that would strengthen the process of democratization, on an efficient functioning of economic institutions, and reforms that offer better conditions for doing business, education reforms, higher social inclusion, and providing equal education and employment opportunities to young people.

2.1.2 Public Sector Efficiency

A summary of the inefficiency of Serbia's public sector and why it this problematic is summarised in the following quote: "An oversized and inefficient state, weak governance and poor public service delivery are barriers to faster growth" (Goldstein, Kopaonik Business Forum, March 2017). In 2015 and 2016, Serbia managed to significantly lower the fiscal deficit and stop the growth of public debt. But in order to reach the full stabilization of public finances, as one of the key pillars of sustainable economic growth, it is necessary to finalize the many times delayed reform of the public sector.

The main result, the reduction of the fiscal deficit, was achieved by reducing public sector salaries, progressively lowering pensions, and by the improved collection of VAT and social contributions. The second austerity measure with high expectations was the reduction in the number employees by 75,000 (compared to the total number of 750,000) in public enterprises and SOEs). However, in the absence of more detailed analyses of the real needs in the fields of education, healthcare, public administration, etc., this measure was quickly abandoned. In practice, that number decreased mostly due to retirements and a hiring freeze. One could argue that the main problem is not over employment, but the structure and low efficiency of the employed. Another important task – reform of public sector salaries – was also not achieved.

There was no serious reform of public enterprises (ownership, organizational and staff restructuring or any rationalizing of the number of employees) while the budget coverage of their losses continued, as well as the issuance of state guarantees for their borrowing. One should also mention low prices (below costs of production) for political and social reasons. There is a big resistance to these changes in the public enterprises, fuelled by political partisan interests where partisan hiring is used to strengthen the power and influence of political elite.

The government is still hesitant to stop providing generous state aid to large SOEs, and thereby delaying the solutions to these issues for years for political and social reasons. In 2017 alone, the state allocated 40 billion dinars or 0.9 % of GDP to covering their losses, mainly for salaries. (Petrović et al., 2017, p. 6). The solution lies in privatizing or finding strategic partners for these enterprises, or in liquidating them with ensured social program for the employees.

Finally, concrete reforms in education, healthcare and other areas have not even been seriously started, so the services provided by the state to the citizens and the business sector are still inefficient and of poor quality.

In short, the effects of the efforts of stabilizing the public finances that have been, so far, put into practice can quickly evaporate, the short-term austerity measures will be exhausted, and the sacrifices made with lower pensions and salaries could prove to be futile if thegovernment does not move faster and more decisively toward solving these issues.

2.1.3 The Grey Economy

According to some estimates, the grey economy in Serbia constitutes a staggering 31 % of GDP (Krstić, 2015) or around 10 billion euro, and it is the highest in the region save for Bulgaria. It is most present in agriculture, trade, construction, and the textile industry. According to some estimates (Nikolić,2017), the official GDP is underestimated by 13–14 %. The main forms of the grey economy are informal employment, salaries paid in cash, paying social contributions to minimum wage, and not issuing fiscal receipts. Such a high share of grey economic activity has negative effects on the economic growth, indirectly because it decreases tax revenues which could be spent for public investments and education. On the other hand, due to the large share of grey economy, a part of GDP is lost because many companies in the formal sector fail due to the unequal conditions of doing business with companies in the grey zone. A certain reduction of the grey economy started in 2015 when the government intensified the activities of tax authorities and inspection services. Stricter penalties for tax evasion were introduced, as well as the system of *ad valorem* penalizing. Considering the size of the grey economy, it is important to continue with a more serious reform of the tax authority, its modernization, capacity building, and higher staff motivation (Arsić et al., 2017, p. 28).

3.2 Macroeconomic Policy

3.2.1 Fiscal Policy

Experiences from the previous period and empirical analyses show that there exist poor conditions for achieving sustainable economic growth in Serbia with an expansionary fiscal policy. The fiscal policy conducted in the period 2009–2014 has shown that despite the fast growth of fiscal deficit, no economic growth has been achieved, because the additional government borrowing was mainly used to cover the losses of the public sector including salaries and pensions.

An expansionary fiscal policy would not be able to significantly affect the economic growth due to the poor effects of fiscal multipliers. The fact is that for the past several years, the potential and the real GDP of Serbia have been pretty even, i.e. there are not many unused export capacities available. In such conditions, faster economic growth, primarily depends on factors on the supply side: building new production and export capacities, improving the educational and qualification structure of the labour force, a much higher efficiency of the institutional framework in which the economy operates (Arsić et al., 2017, p. 27). When it comes to current public revenue and spending policies, a positive effect on economic growth can be achieved through the reallocation of budget funds to public investments for public facilities and public utilities, higher investment in education, R&D, and a better selection of programs financed from the budget (agriculture, incentives for entrepreneurship development, etc.) (Ibid). When it comes to public revenue policy, having in mind that the existing tax burden in Serbia is comparable to the EU, a possibility of a partial tax reduction for employers should be considered. That would create a space for higher investments and employment, while the budget gap could be compensated by legalizing the grey economy and no longer covering the losses of public enterprises and SOEs.

3.2.2 Monetary Policy

In the past, Serbia has had a negative experience with expansionary monetary policy. In a dual currency system dominated by euro, a more expansionary monetary policy would quickly affect an increase in prices and foreign exchange rates with high uncertainty as to its contribution to a bigger credit activity of the banks toward the business sector and the citizens.

In Serbia's banking system the euro is the dominant currency, where assets and liabilities are indexed in euro. The highest percentage of retail and wholesale loans, especially mid-term and long-term ones, are denominated in foreign currency or indexed according to the exchange rate movements, which is a challenge to the financial stability of the country. On the other hand, a dual currency system with a still low country credit rating affects the relatively high interest rates, which lowers the demand for loans and has a negative effect on economic growth (Šoškić, 2016, p. 304–305).

Since 2009, Serbian monetary policy has been based on targeted inflation, which is directed toward achieving a mid-term stability of the prices (the targeted inflation for 2017 is 3% with an acceptable deviation of 1.5 pp). The main instrument is the reference interest rate, which was 4% from the beginning of 2017. At the same time, the government has been conducting a policy of a managed floating exchange rate that enables Central Bank interventions in case of significant short-term fluctuations on the forex market (NBS, Annual Reports on Monetary Policy). Regardless of the difficulties in implementing such a monetary policy in conditions of a euro-dominant dual currency system (Fabris, Gajić, 2016, p. 346) in the period after 2014, there has been a more permanent reduction of inflation, a relative stability of the exchange rate, with relatively high reserves (at the level of a six-month value of imports). Under the current conditions, the existing monetary policy should not be changed. Further cautious reductions in the reference interest rate and mild depreciation of the dinar for the purpose of higher exports and economic growth should be conducted depending on the successful continuation of fiscal stabilization and favorable international factors. The Central Bank should focus more on further decreasing the NPLs of commercial banks and higher "dinarization".

3.2.3 Investment Policy and Export Orientation

The biggest obstacle to faster and more sustainable economic growth is the insufficient share of total investments in GDP. The average share of investments in GDP in the period 2010–2015 was around 18%, which is considerably lower than in comparable countries of the region. A high and sustainable annual economic growth rate of 4–5% requires an increase in the share of investments (domestic and foreign, private and public) in GDP to 23–25% (Stamenković et al., 2016, p. 67).

How to increase the share of investments in GDP? The main efforts should be directed toward increasing private domestic investments and public investments. Already highly present FDI (30% of all investments) should be directed toward export-oriented production with a higher value added, which requires a higher level of qualifications among employees and enables higher wages as well.

Private Investment

The share of domestic private investments (national savings) should be increased from around 11% to

15 % of GDP (Petrović et al., p. 13). The main problem is the still unfavorable business environment affecting mostly the sector of small and medium enterprises (SMEs) and domestic entrepreneurs. This sector employs two thirds of the total labor force and turnover of the non-financial part of the economy, but it contributes with only one half of the total domestic investments, while the other half goes to big enterprises (Ibid). SMEs and entrepreneurs endure more pressure from local political power and municipal bureaucracy. They are faced with big delays in collecting their receivables. The grey economy is a big problem for all participants operating legally on the market, access to bank loans is hindered, and numerous fiscal and para-fiscal burdens (especially at the local level) make doing business more difficult, thereby discouraging investments. Large companies fare better in such a business environment, as they can resolve their issues with direct contact with the appropriate ministries (Ibid). This especially goes for foreign-owned companies, which avoid their responsibilities when it comes to the right of workers to form unions and use collective agreements to ensure acceptable working conditions and wages. Only in 2016 did the state, with the help of the EU, define a more comprehensive programme of support the domestic SMEs and entrepreneurs, which primarily included grants and favourable loans for starting up and developing a private business, but the overall business environment is still improving slowly.

Public Investment

Public investments have a strong positive effect on economic growth. In the period 2011–2015, public investments in Serbia were around 2.3% of GDP, which is significantly lower compared to CIE countries that had average public investments of 4.5 % of GDP. In 2016, public investments increased to 3.1% (the plan for 2017 is 3.3 %), which is still not enough, because a dynamic and sustainable economic growth requires the public investments to increase to 4–5 % of GDP (Arsić et al., 2017, p. 31). The problem is the existing inefficiency of public investments especially where local companies are contracted. The submission of project documents is not timely, legal and property issues take too long to resolve, etc.

Funds for increasing public investments, without additional borrowing and lowering salaries and pensions, can be found in the budget (central and local ones) if the government stops covering the losses of public and state-owned enterprises and reduces the grey economy. Another issue is increasing the investments of public enterprises, which is necessary because some of them are implementing a policy of disinvestment. Finally, there are considerable and favorable credit means of international financial organizations available, which are not being used because investment projects are not ready (Petrović, 2017, p. 13).

Foreign Direct Investments

In the current conditions of low domestic savings, a faster and sustainable export led growth requires FDI. In the period 2001–2008, a large share of FDI was realized through privatization. There were small positive effects of FDI on the growth of productivity and exports and they contributed very little in terms of modern methods of company organization and management, spill-over effects, or in the reduction of the country's political risk (Gligorić, 2016, p. 72). During the recession (2009–2014), FDI stagnated (with the exception of 2011), at an average rate of around 4.0 % of GDP. As a result of the improved credit rating of the country in 2016, FDI increased to 1.8 billion euro (around 6 % of GDP) per year. Greenfield investments dominated, mostly in the processing industry, which is primarily export oriented. These are mostly labor-intensive productions requiring a low or middle technological level, while the share of highly technologically-intensive products was significantly lower (11 % compared to EU28, where this share is 24 %) (Report on Serbia's Economic Development in 2015, Ministry of Economy). Foreign-owned companies mainly employ workers with a lower or mid-level education and pay relatively low wages. Only recently has there been an increased interest in investing into IT and hiring highly qualified workers with considerably higher wages.

The main issue is that the policy of investment, export and employment is to a great extent based on substantial state subsidies. This type of policy is not sustainable in the long term. First of all, huge funds are being allocated from the state budget (3,000–10,000 EUR per job created, which in total is close to half a billion euro for 60,000 jobs) without a more detailed analysis of the real effects and looking at the long-term impact on the educational and economic structure of the country. Second, relying exclusively on subsidies and cheap labor as a policy of attracting foreign investment actually shows that there are still significant weaknesses in creating a stable and predictable business and investment environment. The efficient functioning of the institutions of a market economy and a legal state is the only long-term sustainable strategy that should be implemented.

3.2.4 Employment Policy and Investment in Education and R&D

High unemployment is the major economic, social and political issue in Serbia. It has been the result of several factors: uncontrolled privatization and the de-industrialization of the country in the first stage of the transition (2001–2008), the decline and stagnation of economic activity (2009–2014), the gap between supply and demand in the labor market when it comes to the educational and qualification structure, and the high number of people working in the grey economy. Although the unemployment rate dropped to 15.3% in 2016, the data are still worrying, especially concerning youth unemployment rate which is 31.2%, while the European average is around 18.5% (Head of National Employment Service, march 2017).

The current employment policy is being conducted in several directions: subsidizing investments, primarily FDI, in line with the number of jobs created; subsidy programs for domestic SMEs, including favorable loans for procuring equipment and grants for start-ups; financing vocational training programs; introducing a dual education system (which is currently, frequently debated), which would connect the qualification structure of the labor force with the actual needs of the labor market. University curricula is slow in changing, even though there is a gap between the supply and demand at the graduate labor market.

Employment waiting time, low wages (the average monthly net wage is around 380 euro) and even more a feeling among most young people that there is a low possibility of matching qualifications and jobs, having a decent salary and advancing at work, have all led to a real exodus of young people abroad. The number of emigrants, which is dominated by young people, average around 26,000 a year, and that number increased to 45,000 in 2013, and reached a record high of 58,000 in 2014 (OECD, 2016). Serbia is losing precious human capital this way and is practically financing the most important production factor for the needs of developed countries. Lack of any kind of policy on this issue is confirmed by the fact that Serbia is ranked 134 out of 137 countries by the capacity to retain talent, and 132 to attract talent. (Competitiveness Report, WEF, 2017–2018).

All this speaks to the fact that big changes are needed in the education system, particularly the modernization of obsolete educational programs, starting with primary and high school education. It is necessary to adjust in the long term the educational and qualification structure to the rapid technological changes and new knowledge and skills that are expected.

Higher investments in education, new knowledge and innovation are key to a higher competitiveness of the economy and a better position of Serbia when integrating with other countries in the region and the EU. Serbia invests only 0.73% of GDP in R&D compared to EU28 where the average is 2.03% of GDP (2015). It is also worrying that there is almost no private financing of R&D (only 8.2% of total investments compared to 55% in EU28), which reflects a still low production and technological structure of the economy, and a low interest in investing into applied innovation development (Report on Serbia's Economic Development in 2015, Ministry of Economy, 2015).

4. Reduction of Poverty and Income Inequality

In 2016, 7.3% of the population (over half a million) in Serbia lived in absolute poverty, below the poverty line (about 96 euro monthly income), which is among the lowest in Europe. This percentage is not declining significantly over time nor is the profile of those in poverty changing: low educational level, distance from the labor market, distance from the urban centers, and the ratio of the number of dependents and working-age persons in the household. Poverty is more often widespread among households with more members and more pronounced among children and youth (B. Mladenović, 2017). According to SILC data, 41.3% of the population was at risk of poverty or social exclusion in 2015. This is much higher than the EU average (24.8%) and higher than in other EU countries, except in Bulgaria and Romania. Broken down by risk factors, a total of 25.4% of the population of the Republic of Serbia was at risk of poverty (among the highest in Europe), with children and youth being the most exposed, 24.0% were severely materially deprived, and 15.6% lived in households with low work intensity (Social Inclusion and Poverty Reduction Unit,2017).

The inequality, if measured by the level of consumption, is not too high compared to EU countries (Gini coefficient is 0.26 and the ratio between the richest and the poorest 20% is 4:1). However, when inequality is measured by income (using SILC data), the Gini coefficient rises to 0.38 and the ratio between the richest and the poorest group doubles to 9:1, which was in 2015 the highest income inequality when compared to all EU countries (EUROSTAT). This difference between consumption and income inequality can partly be explained by still persisting home-made production in poor rural areas (over 12 % of their consumption), which is not included in SILC surveys (B. Mladenović, ibid.).

Eradication of extreme forms of poverty (i.e. absolute poverty) demands changes of the existing social system and of social policy. Only half of the poor are beneficiaries of social assistance. This assistance is low and not sufficient to lift the poor above the poverty line. All main indicators of the quality of social protection – scope, adequacy and targeting – need to be improved. First, changes in the Law on Social Protection and Law on Financial Support for Families with Children are necessary in order to increase two of the most important cash payments (financial social assistance an child benefit). Secondly, eligibility criteria and entry of new beneficiaries have to be more transparent. Thirdly, administrative procedures have to be simplified and the activities of Social Centers on the local level have to be better organized. Of course, the basic solutions of poverty eradication are better employment possibilities, better access to education and better housing conditions out of urban centers.

Any increase of public expenditures on more social assistance demands an increase in revenues. The main source could come from further legalization of the grey economy which could increase tax income by 1% to 2 % of GDP. This increase of public revenues is possible if a serious reform of tax authority is undertaken.

When it comes to high income inequalities one has to keep in mind that the (flat) income tax in Serbia contributes only 4 % GDP to public revenues, which is less than half of the European average. Because the income tax in Serbia is basically a flat tax with minimal progressiveness, it decreases income inequality (measured by Gini coefficient) by less than 1 p.p. which is significantly less than in European countries (Arsić, Ranđelović, 2017, p. 82).

Poverty and inequality reduction is possible by increasing social transfers (without current social transfers the absolute poverty rate would be 9.9 % instead of 7.3 %) and, on the other hand, by introducing, a more progressive system of income taxation.

In Serbia, about 350,000 employees receive the minimum wage, which for 2017 is about 190 euro per month, (about 63 % of the minimum consumer basket). After long negotiations in the Socio-Economic Council, social partners – trade unions, employers and the Government – have accepted that the minimum wage for 2018 will be increased by 10 %, or by 19 euro which is still not enough to cover basic needs. This is just one example of the weak negotiating position of the trade unions in social dialogue, which has been pointed out in all annual reports of the Economic Commission on Serbia's progress in the process of EU accession.

There are many reasons for the weak negotiating position of the trade unions. First, in Serbia the process of transition, strangely enough, strengthened the position of the state in relation to the other two social partners. The state has used this and has contributed to increasing conflicting relations between trade unions and employers and thus become the decisive factor in the Socio-Economic Council. In addition, there are many differences within the trade unions themselves, each looking for a dominant position. The trade union membership is decreasing as well as is the readiness for industrial action for fear of losing job. The employees in the public sector are more protected than the workers in the private sector. An additional problem is unfavorable position of trade union organizations in foreign-owned companies where the employers try, in spite of the law, to avoid trade union activities.

5. The Role of EU-Implementation of External Policy Conditionality and Fund Absorption Capacity

Full membership in the EU has been Serbia's main goal since 2001. The accession process is going slowly due to the slow fulfillment of the necessary conditions by Serbia, but partly because of the political conditioning by the EU as well. Visa liberalization was approved only in 2009 when SAA and Interim Trade Agreement began to be implemented. Serbia became a candidate country for full membership in March 2012, and first negotiation chapters were not opened until the end of 2015.

The economic benefits of EU integration are obvious. Serbia does around two thirds of its foreign trade with the EU. EU member states are the biggest investors in Serbia and most of the foreign banks are from the EU. Serbia received most of its development aid and favorable loans from the EU, EIB, EBRD and member states. Once it becomes a full member of the EU, Serbia as an underdeveloped country with a significant share of agriculture will have a favorable position in using EU funds (Uvalić, 2012, p. 8).

With over 3 billion euro from 2000, the EU is Serbia's biggest donor (75 % of all donations), including 3 billion euro from EU member countries. In the same time, Serbia is an important beneficiary of favorable loans (EIB over 4 billion euro) and others.

The direct impact of EU funds (IPA) on economic growth is limited by the current status of Serbia as a candidate country, which allows it to receive annually around 200 million euro in grants (1.51 billion euro in the period 2014–2020), which stimulate economic growth through programs of building institutions, cross-border cooperation, regional cooperation and the development of human resources. The absorption capacity of IPA funds increased to 86.9 % in 2016–2017.

The EU is actively involved in the implementation of economic, social and political reforms. EC Progress Reports on Serbia are an important incentive, but also a corrective factor in this process. Notably, in the last two or three years, there have been some positive assessments of the implementation of economic reforms and macroeconomic policy, while the main objections have been made to the slow or moderate progress of judiciary reforms, the independence of institutions and regulatory bodies, and freedom of the media. One should add that the EU is politically, but also with concrete programs, particularly in the field of energy and transportation, contributing to more intense regional cooperation in the Western Balkans (Western Balkans Summit, Trieste, 2017). Though there are some doubts about future results, Serbia should, following its own interests, continue to be among the leaders of this process.

The main reason behind Serbia's slow road to the EU is of political nature. On the one hand, the EU has been burdened by internal issues of the Union for quite some time, including Brexit, the lack of a unified policy on solving the migration crisis, different interests concerning the relations with Russia, etc. When it comes to Serbia, there are special political demands. The most important is a constructive attitude from Serbia and the full commitment in implementation of the Brussels agreement with Kosovo (which is covered by a special negotiation chapter). Since the very beginning (2013), the realization of the Agreement has had numerous problems, delays and suffered from the lack of implementing previously agreed solutions. The EU should play a more active role in this process.

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Slovenia – Towards a Coherent Growth Policy

Milan Martin Cvikl and Anton Rop

Executive Summary

- Following a successful entrance into the European Union and the adoption of the euro, Slovenia has changed its economic policies into ones that are pro cyclical. The country was badly hit by the financial crisis. It took five years, early elections and three changes of the government to implement bold measures, restoring confidence.

- Growth has been slowly restored on the wings of exports, however over the medium term it is likely to decline, unless risks are managed well. Further reforms and measures will ensure sustainable progress by implementing a credible, reform-based, fiscal strategy to contain public debt at manageable levels. These reforms and measures aims to ensure:

  - a sustainable pension system and the adjustment of the social protection system to the aging population;

  - labor market reforms, improving the system of labor market flexicurity, the efficiency of labor force allocation, and reducing labor market segmentation;

  - improving sustainability and efficiency of the health system;

  - improving public sector efficiency, the education sector and research and development systems, making them growth conducive;

  - ensuring the absorption of the EU funds of pan-European Investment programs and development investments by IFIs;

  - conclusion of the restructuring of the banking system;

  - further enterprise restructuring and the improved corporate governance of state owned enterprises to ensure their competitiveness and appropriate returns for government related purposes.

- However, Slovene sustainable growth, given its export oriented economy would ultimately depend on the overall economic developments in its trading partners and of the European Union. Slovenia should attempt to remain within the core of the European Union, Euro-Area and other "unions" to be developed in the post-Brexit EU and pursue the further internationalization and competitiveness of Slovene companies.

1. Slovenia's Pre and Post 2008 Financial Crisis Economic Developments

1.1 A Small Open Economy Acquired the Euro in 2007 and Was Immediately Exposed to the 2008 Global Economic Crisis

Upon its entrance to the European Union, Slovenia[1] aimed to adopt euro as the first among the 10 new Member States of the 2004 enlargement and thus to align with the most advanced EU economies. Achieving this objective proved extremely important in the wake of the financial crisis. The crisis hit the globe the year Slovenia, for the first time ever, was enjoying some price and currency stability and access to external financing.

The latter was proven to be a rotten apple as the highest GDP growth rates of 2006–2007 were spurred by domestic demand due to a construction sector bonanza, fiscal expansion, management buyouts, and wage increases, all of which were financed by short-term lending, which was financed by external borrowing.

Ultimately the crash of 2008 came as a shock: liquidity was siphoned off and solvency problems occurred, especially once banks and the country lost access to international capital markets. Management buyouts collapsed as highly leveraged short term financing abruptly stopped for economic and political reasons. Fiscal revenues dropped and despite government cuts in expenditures, deficit and debt increased dramatically. Slovenia was close to request a Troika Program, like the one for Cyprus, but avoided it by bold domestic measures imposed in 2013 by a Domestic Troika – the Minister of Finance, the Governor of the Central Bank and the then Prime Minister.

Before this, following the implementation of the 2004 Government program for the adoption of the euro, Slovenia ensured a soft-landing of the economy and Slovenia joined the then 12 current members of the eurozone, and was the first among the EU-10 member states that joined in 2004 to adopt the single European currency, doing so on January 1st 2007. The adoption was part of a well-prepared project that saw all of the relevant policymakers fulfilling their task to ensure a positive outcome:

- the fiscal deficit and public debt were, up to 2004–2005, kept within the Maastricht levels with a sufficiently safe margin;
- the impact of administered prices on inflation was contained by encouraging monopolistic structures to care about costs, while preparing further steps to increase competition;
- a careful public wage policy that spurred employers and employees to settle for wage increases that lag productivity growth and hence reduce the cost-push and demand pressures on inflation;
- by lowering inflation in a sustainable manner to enable the smooth entering in the ERM II, the country succeeded in keeping key interest rates at appropriate levels.

The resulting convergence of inflation to the Maastricht levels allowed for the convergence of nominal interest rates down to the level of the eurozone's interest rates without affecting the achieved macroeconomic balance. A minor current account deficit and modest GDP growth rates were in line with Slovenia's economic fundamentals.

These government policies should have continued. However, starting in 2005–2007 the policies changed and became more pro cyclical in all aspects of fiscal revenue and expenditure policies. Taxation was reduced by the reduced progressiveness of the country's personal income tax and reduction of the profit tax. Wage policy became loose, a new public sector wage agreement was agreed to with all groups and they gained increases or promises of increases. On the expenditure side while increasing expenditures the government for example requested that the Highway Corporation borrow funds on the market, instead of a continuation of the provision of a direct budget subsidy as in the initial years. However those reduced expenditures were replaced by other recurrent expenditures, instead of investment expenditures. Thus medium term fiscal balances worsened. Delays in the implementation of the initial years of the EU Budget Multi Financial Framework (MFF) 2004-06 in the MFF 2006-07 and the advancement of EU related expenditures resulted in delayed refinancing from the EU budget, also creating additional fiscal imbalances.

From 2005 onwards political interventions into the corporate sector deepened. Initially, changes to the legal framework enabled massive, highly lever-

1 On the developments up to 2004 see the most comprehensive review in *Slovenia – From Yugoslavia to the European Union, editors Mojmir Mrak, Matija Rojec and Carlos Silva-Jauregui, The World Bank 2004,* where different authors discuss issues of The Road toward Political and Economic Independence, Socioeconomic Transformation – Slovenian Way and The Quest for EU Membership. For shorter review see parallel FES study *Jože Mencinger, Formulating Sustainable Growth Agenda, Experience of Slovenia, 2017.*

aged management buyouts. This was enabled by domestic lending and banking credits, increased at the rate of 30 percent and 40 percent in 2007 and 2008 respectively. The banks were enthusiastic to cooperate by borrowing cheap money abroad: as a result the credits/deposits ratio increased from less than 1 to 1.6 and net foreign debt from 0 euros in 2005 to 10 billion euros in 2008. The Slovene stock exchange index (SBI), which had up to then had followed the growth of nominal gross domestic product, tripled in less than two years, just before the financial crisis.

This opened a capital Pandora's Box in Slovenia as growth was financed by huge foreign capital flows and debt. The unprecedented increase of current account deficit following the entry into the EU and the eurozone can be thus explained by "financial deepening", buying securities at home and abroad[2]. Economic growth increased beyond a "natural" rate at 4 percent and in 2007 reached 6.8 percent (mainly due to 15 percent growth in construction and financial services).

Slovenia aborted its cautious policies up to 2004 and became part of an overall "financial bonanza" process, when an outstanding amount of cross-border loans to CEE countries increased from 94 billion US dollars at the end of 1999 to 666 billion US dollars at the end of 2008. The exposures of BIS reporting banks in CEE economies, were five times higher than those in emerging Asia, when compared to GDP (Herman and Mihaljek, 2010).

These credit booms have not only contributed to GDP growth, but have also led to a sharp increase in current deficits, rapid debt accumulation, huge assets price appreciation and general overheating of the economies. For these reasons the most liberalized and opened emerging countries including Slovenia, became the most vulnerable ones once the financial crisis erupted. All of the above borrowing namely in Slovenia resulted into a doubling of gross external debt from some 20 billion euros in 2004 to 40 billion euros in 2008 (IMAD Development Report).

The vulnerability of Slovenia resulted in 2009, of a 7.9 % drop in GDP, a drop in exports over 15 %, and a fall of gross fixed investments by more than 30 %. The use of expensive, counter cyclic fiscal policy measures helped to make the fall in GDP in 2010 lesser than it would had been otherwise. The associated result was a very high general government deficit and large increases of the public debt in the first five years since the beginning of the crisis. The crisis in domestic demand deepened in 2011, when government consumption declined alongside the contraction in investment and household consumption.

1.2 An Overview of Recent Economic Developments and Base Line Growth Projections

1.2.1 Recent Economic Developments

Since 2012 GDP growth has only gradually picked up. It is an export driven growth which increased in 2012–2015 due to the rise in global demand. GDP also increased due to some domestic demand driven by the implementation of EU funds and rise of services industry, including tourism. Since 2012 the pace of abrupt fiscal consolidation has also slowed, while monetary easing at the EU level positively affected the real economies in Europe.

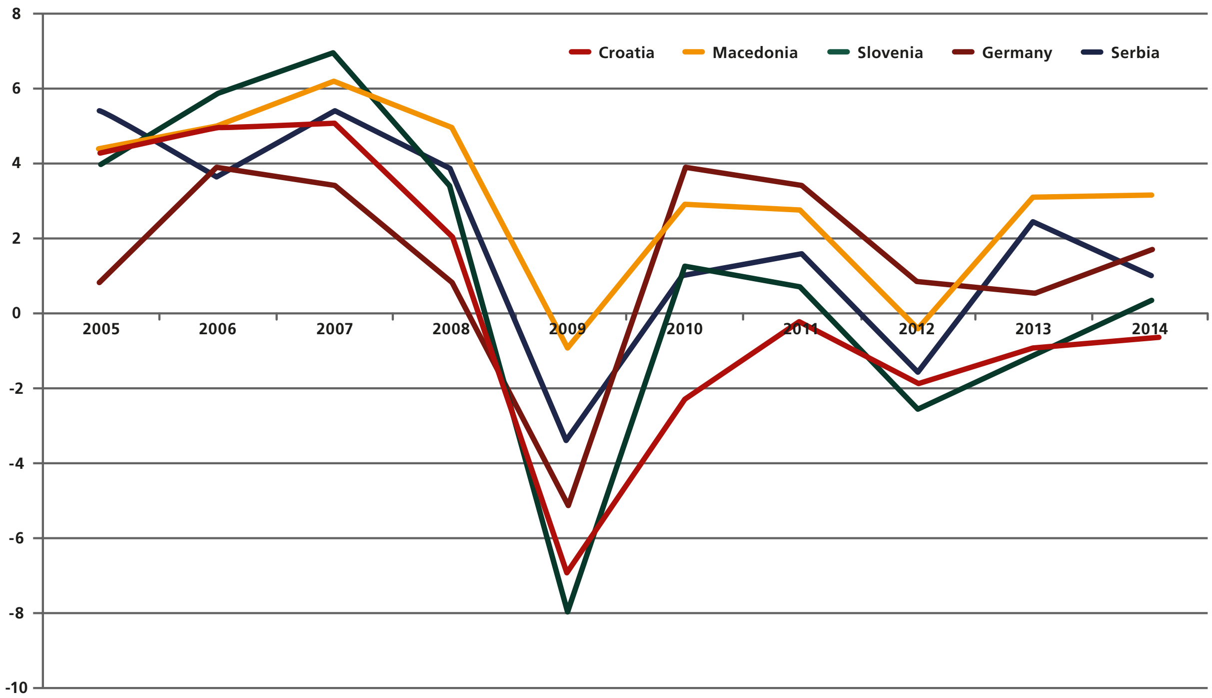
In Slovenia though, there was, a structural tightness with limited foreign bank funding, due to a significant number of over-indebted companies and households. Fiscal consolidation had to continue and further fiscal measures were needed. Overall improvements in the global financial situation have helped because since 2010, global demand has started to grow and has been continuously growing up to today.

Ultimately, to regain investors' confidence, a major and costly bank recapitalization at the end of 2013 was needed, showing that Slovenia can undertake its own domestic Troika program. Alongside restored sovereign market access due to major Economic and Monetary Union reforms and structural changes at the EU level, the county led the recapitalization and carved out non-performing loans (NPL) into a separate entity, which has stabilized the financial system. And Slovenia was able to launch an export-led recovery in 2014–2016.

In 2014–2016, real GDP thus grew by 8.1 percent cumulatively, employment by 2.9 percent, and real wages by over 4 percent. Growth also become more balanced recently. In 2016, private consumption accelerated, supported by an improvement in business expectations and sustained wage and employment gains. In 2016 public investment was nearly halved, reflecting lower absorption of EU funds (following the conclusion of the previous Multiyear Financial Framework 2007–2013) compared to the one in 2014–2015. Strong private investment – mainly in the export-oriented manufacturing segment – offset some of the decline. Amid

2 See on this also in parallel study *Jože Mencinger, Formulating Sustainable Growth Agenda, Experience of Slovenia, 2017.*

Figure 2: GDP Growth 2005–2014 in SEE Countries and Germany



Source: The World Bank

robust trading partner demand, closer integration in regional supply chains and competitiveness gains, exports remained a major driver of growth. Unemployment declined further, while remaining elevated at 7.9 percent.

By early 2017 Slovenia enjoyed a fourth consecutive year of steady economic growth. This has lifted wages and employment, increasing domestic demand. Financial stability has improved and Slovenia's external position has further strengthened. It was thus reported by IMF staff, during its most recent Article IV consultation mission[3], and by IMAD in its 2017 Spring Forecast[4], that sustained efforts to restore financial stability and pursue prudent macroeconomic policies since 2013 seemed have to paid off well for Slovenia.

Financial sector stability has also improved considerably. Following strong capitalization and selling of NPLs, banks' capital position is strong, and liquidity ample. The decline in bank credit has bottomed out, with credit to households growing robustly. The steady decline in NPL ratios has strengthened bank balance sheets, and the corresponding release of provisions has raised bank profitability.

3 IMF Slovenia: Staff Concluding Statement of the 2017 Article IV Mission, March 28, 2017

4 IMAD, Spring Forecast 2017 at http://www.umar.gov.si/en/public-info/news/release/news/pomladanska-napoved-letos-okrepitev-gospodarske-aktivnosti-na

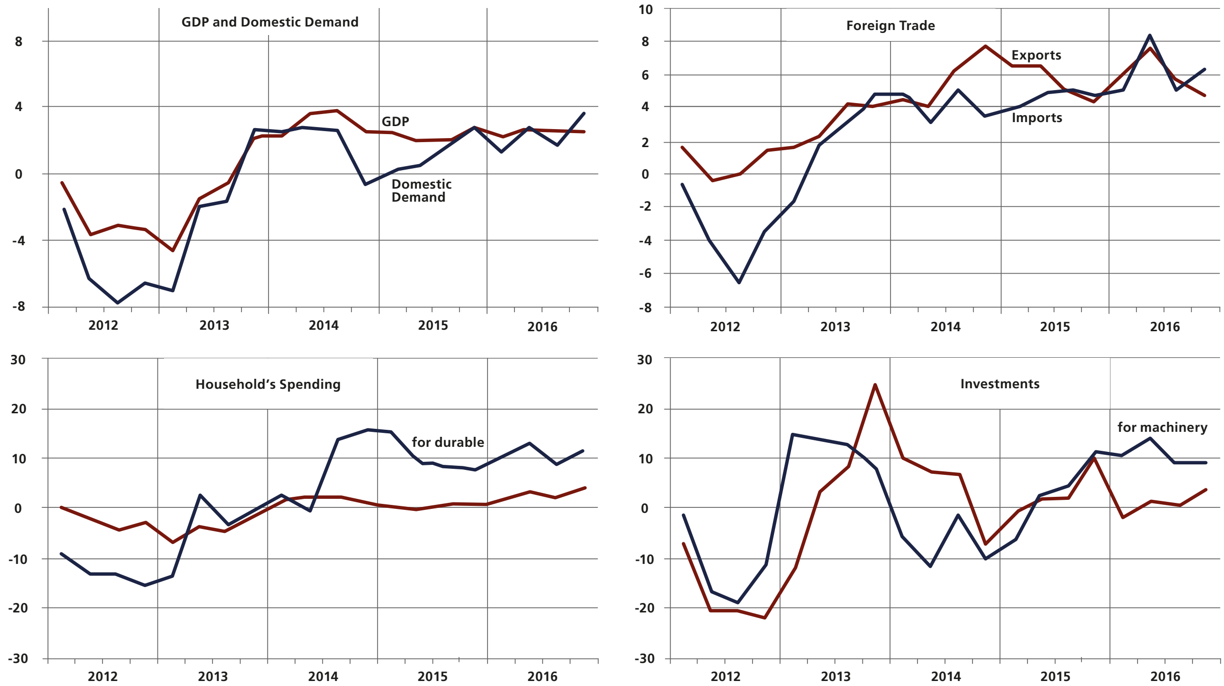
1.2.2 Base Line Growth Projections

For the future the IMF and the Slovene Institute for Macroeconomic Developments (IMAD) both expect further robust growth in 2017, with the less favorable medium-term outlook. The IMF projects 3 percent GDP growth in 2017, closing the output gap, IMAD projected a more optimistic 3,6 % in its most recent Spring Forecast of March 2017. This has been increased with the updated Fall Forecast of September 2017 to 4,4 %. There are similar upward estimates from the European Commission and the Bank of Slovenia.

Private consumption should remain strong, aided by continuing employment and wage growth. Private investment should continue its 2015–2016 rebound, with capacity utilization near historic highs, strong profitability and comfortable financing. Public investment should also grow strongly. For this to remain robust the absorption of EU structural funds would need to quickly recover to its 2014–2015 levels. However this is hard to expect as the implementation of the MFF 2014–2020 started slowly. Rising demand in Slovenia's trading partners is expected and exports should continue boosting growth, subject to external risks. The labor markets' situation should improve in 2017 and 2018, taking into account economic growth and demographic changes.

While positive growth projections for 2017 and 2018 over the *medium term* of the growth picture are

Figure 3: Dynamics of Final Demand, 2012–2016 (in %)



Source of data: SURS, BS

less favorable. The IMF projects for example annual rates converging to the estimated potential growth rate of 1¾–2 %. This low potential growth rate is constrained by adverse demographic trends and the sluggish growth of its major trading partners.

The IMAD Spring Forecast envisages GDP growth strengthening to 3.6 % in 2017 and then to be reduced to around 3 % in 2018 and 2019, assuming stable international economic conditions and continuation of favorable economic developments in Slovenia with the implementation of the announced economic policy.

There are risks to positive scenario. Those from the international environment, are mainly negative. They are related to the high level of political uncertainty linked primarily to the framework for the future functioning of the EU in connection with Brexit and the outcome of elections in some of Slovenia's main trading partners, and the new US administration's policy measures.

In the domestic environment risks are predominantly, mainly related to the dynamics of investment. With a revival in lending and an even lower level of uncertainty in the business environment, private investment could be higher than under the baseline scenario. Government investment in 2017 (and in later years) could be lower than forecast, with different dynamics of the absorption of EU funds than planned. Household consumption could also be higher than assumed under the baseline scenario, especially if disposable income were to increase even more as a result of even more favorable developments on the labor market.

To sustain these risks and to ensure high sustainable growth patterns more has to be done on the reform side. This should ultimately provide better well-being for most of the citizens by ensuring sustainable and progressive growth of the GDP in Slovenia.

Reforms, policies and measures should thus support a further increase of competitiveness to increase the portion of the economy with higher value, adding to the Slovene growth potential. At the same time, and to ensure social cohesion, appropriate social policies should sustain the well-being for most of the citizens. Before we discus those reforms and policies, we provide a short overview of the Slovene reform capacities and its challenges.

2. Overview of Slovene Reform Capacity and Challenges Calling for Structural Reforms

2.1 Key Domestic Obstacles to the Coherent Growth Policy

Building competitiveness while assuring fairness in society demands that Slovenia further develop its reform capacity and manage its policy challenges and reforms. Currently, the major obstacle to the Coherent Growth Policy and challenges to a sustainable high growth in Slovenia is high public debt, piled up over the last couple of years. Furthermore there are demographic challenges, high levels of unemployment, especially for the younger generation, a credit crunch and a lack of a innovative business environment.

Though public debt has declined from its peak it remains high, limiting space for government intervention and government investment – notwithstanding potentially available EU funds. The economy's potential growth rate is low, except for an increase that is export led and/or driven by private sector consumption.

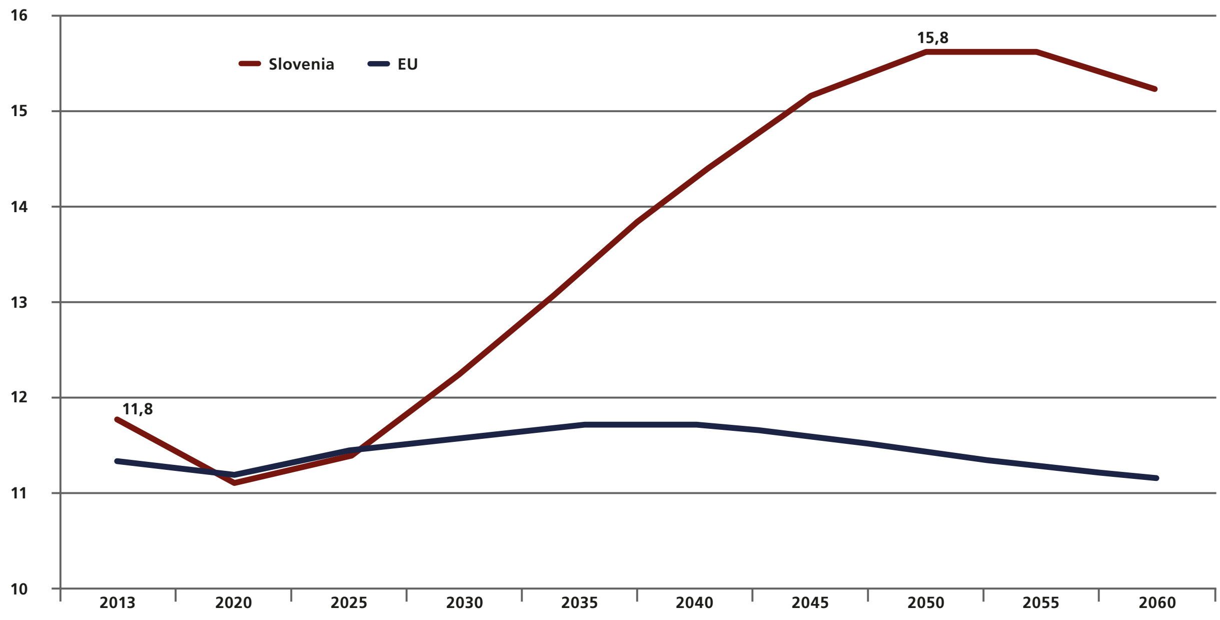
Growth has returned since 2012/13 but it should be noted that the level of Slovenia's GDP and employment remain below their pre-crisis levels. In terms of percentages of GDP and related strings, very expensive bank recapitalizations and the two deep recessions since 2008, nearly quadrupled public debt by 2015. Fiscal consolidation since 2011 has relied on a mix of structural reforms and one-off measures, especially on wages and employment. Wage policy is now being reverse with pressures from the public sector trade unions for an increase of controlled wages.

The age structure of the Slovenian population is projected to dramatically change in the coming decades, due, in particular, to an increasing longevity and low fertility. The population aging trend poses the most important fiscal sustainability challenge in the medium and long-term, as (all else being equal) larger cohorts of pensioners put pressures on public pension expenditures. The impact of aging on pension spending in Slovenia is projected to be substantial, from 11.8 % to 15.8 % of GDP till 2050. This is the highest projected level and growth of pension expenditures to GDP ratio among EU member states.

Despite the progress made with increasing the effective exit age and older workers' participation and employment rates, Slovenia remained more than 10 percentage points behind the EU average in 2015. Mid-term and long-term demographic challenges demand major changes to the pension and related healthcare (especially for the long-term care) systems and policies. Alternatives are major changes to demographic and emigration policy and further reforms in the labor market.

Banks' balance sheets have been strengthened, but the NPLs of SMEs are proving stubborn, reducing the possibility for stronger credit growth to the non-financial sector. The government opted not to repeat its successful rehabilitation with in-house bad debt workout followed by the successful privatization of the one from the period 1994–2001, but have created the Bank Asset Management Company (BAMC) and costly recapitalized banks. It is only now making further steps to conclude the process in a much more difficult environment and under the strings of the EC's conditions. The reinvigoration of structural reforms, including in the banking sector

Figure 4: Pension expenditure in Slovenia, Pension-to-GDP ratio 2013 and 2060



Source of data: EC (2016).

and careful, more effective corporate governance over the remaining SOEs are needed to unleash the growth potential.

2.2 EU and EMU Related Policy Issues

The EU and EMU provide plenty of instruments that could boost government and private led investments. However, Slovenia is a small, open economy with a highly decentralized absorption capacity at the ministry and fragmented, local community levels. Thus it is costly and difficult to timely and to fully absorb the available EU funds.

Furthermore, Slovenia has within the current Multi Financial Framework difficulties in acquiring available funding from the EU Budget and from International Financial Institutions, as well as for bigger projects that could have been funded under EFSI1 or EFSI2 schemes. Difficulties with the utilization of available EU funds under newly established EFSI1 and EFSI2 funds could become even more critical should the use of financial engineering instruments become, in the financial perspective 2020–2026, the modus operandi of EU cohesion and other developmental policies.

In this context it would be critically important to conclude the preparation of some major projects, potentially to be financed under EFSI schemes and/or IFIs or bilateral lending such as: the 2nd Railroad Divača-Koper project, the 2nd part of Karavanka Tunnel, sections of the so-called 3rd Road Axis, further railways modernization, power producing sector operations, especially those contributing to reaching the Paris Agreement's climate objectives, anti-flood measures as well as energy renovation projects of public building and increasing the energy efficiency of old apartments buildings, etc.

Germany, Italy, Austria and France are Slovenia's major export markets and the economy is very much intertwined into major EU companies and other EU member states, as well with markets in Eastern and South Eastern Europe, with Croatia being its third export market. As the current EU structure would look like to end up in the EU within different areas, circles and at different speeds, Slovenia would need to accelerate its reforms to stay within the core EU – eurozone member states. These are those sharing the eurozone and Schengen Area, but also those that would support the creation of a Full Fledged Banking Union, Eurozone Fiscal Union and a more and more needed security Union, etc. Should these create a stronger, more interconnected European Union, Slovenia needs, due to its economic integration, to stay its integral part.

2.3 Political Economy Issues

2.3.1 Slovene Strategies and their Implementation since 2004

According to the IMAD 2016 Developments Report 2016, in the past few years, Slovenia has taken a number of positive steps and as a result slightly narrowed its development gap with the EU. Regardless of these positive shifts, challenges remain in terms of ensuring a more sustainable improvement to Slovenia's growth potential. This should increase the welfare of the population and further reduce the gap. For all these structural changes, reforms and measures are to be implemented.

Among them are the re-establishment of strategic developmental priorities and improving the efficiency of the government and the institutions responsible for making and executing coordinated development decisions. The last one, Slovene Developmental Strategy 2005–2013, prepared in period 2003–2004 that had linked the preparation of Slovenia in entering the EU and to fully utilizing EU funds in the MFF 2004–2006 and 2007–2013, was such a set of policies, elaborated enough that they could have been implemented.

However, it was replaced by a sporadic set of polices implemented by four different Governments. In the period 2004–2008 the Government implemented a growth strategy based on external borrowing to conclude major investment projects, which had overheated the economy. In the period 2008–2011 the Government reacted to the financial crisis with a set of jobs preservation strategies and provision of liquidity to the banking system rather than dealing with the credit crunch problems and ailing banking system. The lack of domestic investments crippled GDP growth, creating major fiscal imbalances and demanded reforms to reduce fiscal pressures. The Government prepared pension reform, but it was turned down in a referendum, causing a political crisis.

Following the first early elections ever called in Slovenia, after some political battles the new Government implemented unpopular fiscal and other policy measures. The result was political unrest and the formation of another Government in 2013. It was only this Government that together with the Bank of Slovenia, after being cornered by the eurozone sovereign crisis in 2011–2013 that resulted in the Troika programs in Greece, Portugal, Cyprus, had prepared and implemented a domestic Troika program.

To assure Slovenia's access to international markets, a bold program of costly banking sector recapitalization, the creation of separate Bank Assets Management Company (BAMC) and the withdrawal of major amounts on NPLs into BAMC, plus additional fiscal measures, were prepared by the domestic Troika. The program included state aid to government owned banks which had to be agreed on by the European Commission, even money from the EU stabilization funds was not made available.

Slovenia then regained access to international financial markets and growth returned to the economy. It could have been easy sailing until the end of the mandate, however, due to inner party fighting, the Government lost a confidence vote and for the second time in a row early elections were called in 2014. In the summer of 2014 yet another Government, the fourth since the crisis hit Slovenia, was formed.

To conclude, the implementation of policies were far from those originally envisaged in the 2004 Slovene Developmental Strategy. Ultimately the financial crisis has altered priorities as Slovenia could not continue to continue with extensive developmental policies of 2004–2008 period based on external borrowings. It took more than five years and changes of three Governments for Slovenia to undertook, credible program, focused on unbundling vicious circle of fiscal and banking sector problems. Implementation of 2004 Slovene Development Strategy should be assessed negatively, though this Government has yet to formally perform an analysis of what had been achieved and what remains to be done with a new set of policies.

2.3.2 The Stability of the Country's Governance

Due to its proportional electorate system the country's governance always depends on a coalition forming the Government. As far as the stability of the country's governance is concerned, since independence Slovenia has had two distinct periods. The first was the period 1992–2004 with stable country governance when there were wide coalition governments led by the center-left Liberal Democracy of Slovenia (LDS). These Governments were led for 10 years by the same LDS party, and two Prime ministers were able to form a consensus on the major reforms linked with Slovenia's transition and entrance to the European Union and NATO. The process of EU membership was especially the one utilized by the Government as an outside push for domestic reforms.

The second period, one of unstable country governance came with the financial crisis. The political elite and ministerial chorus have been quickly changing, with newer and newer ministers, top government officials and more and more new MPs entered each of the three formations of the National Assembly. These influenced the work of the Government and reduced the quality of both Government and Parliamentary work, resulting in sub-optimal legislative proposals.

3. Key Policy Challenges and Reforms to Enable a Sustainable Progressive Development Model for Slovenia

The current results and projections indicate that the Slovenian economy is moving out of the crisis and into a normal state, though the GDP growth of 2.5 % in 2016 remained hindered by the restrictiveness of monetary (banking credit crunch) and fiscal policy (compliance with the EU fiscal rules). The level of GDP is still some 2.4 % lower than the pre-crisis maximum in 2008 and indicates a continued lagging behind the EU average.

Slovenia could increase growth in the near future without problems on the supply side, idle capacities provide enough room for non-inflationary growth. Good short term results bring to the fore the issue of long-term sustainability of current dynamics[5] linked to the most important reform challenges of the Slovene economy and society.

The key goals for the next medium and long-term period should be focused on strengthening stable, progressive economic growth, pursuing the objective of the stability of public finances and long-term fiscal sustainability. Some of them are envisaged by the Government and called upon by the IMF, IMAD and the new Fiscal Council. In the rest of the paper we discuss seven sets of reforms and measures that should ensure:

- a sustainable pension system and the adjustment of the social protection system to the aging population,
- labor market reforms, improving the system of labor market flexicurity, the efficiency of labor force allocation and reducing labor market segmentation;
- improving the sustainability and efficiency of the health system;

5 See parallel study Jože Mencinger, UL and EIPF, 2017.

- improving public sector efficiency, the education sector and research & development systems, making them growth conducive;
- ensuring the absorption of the EU funds of pan-European Investment programs;
- the conclusion of restructuring in the banking system;
- further enterprise restructuring and the improved corporate governance of state owned enterprises to ensure an appropriate level of returns for government related purposes.

These are all an integral part of a reform based fiscal strategy demanded by the high level of public debt calling for fiscal medium-term consolidation. The idea is to eliminate the budget's structural deficit by 2020 and maintain this level afterwards. It is thus planned that this will reduce debt to 60 percent of GDP by 2026. Over the long-term the population's aging and the fiscal reforms are to be implemented from a reform package that reduces age-sensitive spending relative to GDP in the next few years.

3.1 The Sustainability of the Pension System and the Adjustment of the Social Protection System to the Aging Population

For Slovenia the projected demographic trends and related challenges are the key elements of future development and long-term financial and economic sustainability. By 2060, there will be twice as many elderly people in comparison with the working-age population in Slovenia, and the number of people over 85 will also rise. Moreover, among EU countries Slovenia has the largest projected increase in pension spending.

Age-related expenditure projections up to 2060 reveal that, according to the baseline scenario, Slovenia's age-related expenditure will increase from the current 24.7 % of GDP to 31.5 % and the public pension expenditure will rise from 11.8 % of GDP to 15.3 %, which is the highest growth of pension expenditures in the EU-28. In 2060 Slovenia is also forecasted to be on the top in terms of its share of pension expenditure in GDP. In the structure of age-related expenditure, the largest share is taken by the expenditure of the pension system.

A comparison with foreign pension systems shows that the gradual increase in retirement age is a very important element in ensuring the sustainability of the pension system. Increased labor participation is another factor that determines the entitlement to benefits under pension insurance schemes.

Future reforms of the pension insurance system should therefore consider two main elements of change, namely intergenerational solidarity and the principle of intergenerational fairness and equality. With regard to the above, future pension reform must be founded on gradual implementation and also take into account the diversity of financing options to generate adequate old-age incomes. It should be noted that a sustainable pension system that ensures adequate old-age benefits cannot be run without a discussion and the implementation of alternative sources of funding that will be used as a supplementary measure to correct the retirement benefit amounts financed from the compulsory pension pillar.

The introduction of a scheme that would oblige insured persons and their employers to co-finance supplementary pension insurance is essential to ensuring in the long-term adequate and fair pension system. A very important additional pillar of the long-term sustainability of the pension system can also become a Sovereign Pension Reserve Fund – Demographic fund, which should be created on the basis of the transformation and substantially, financially strengthening of the Capital pension Fund – KAD and/or the existing State Sovereign Holding – SDH. This fund would be capable to appropriate govern SOEs and/or portfolio investments and provide financial support to the first pillar of the pension system in the financially tougher years, directly or indirectly via the budget,

Compulsory pension insurance will remain the fundamental pension insurance scheme for individuals in the future; however, a general public consensus will need to be sought to specify the contents of the fundamental principles on the basis of which the system will successfully operate in the future and be able to withstand the changing social and economic conditions.

A sustainable, adequate, fair and efficient pension system is the most challenging financial, social and management issue for the future of Slovenia. There is no doubt that the above challenges should only be resolved with continuous adjustments and reforming of the pension, as well as the social protection system together with additional measures in the labor market.

Ultimately the most important tasks in the field of pensions are:

- Ensuring adequate income for all generations, with the help of the supplementary pension schemes;
- ensuring the long-term sustainability of the pension system by establishing a multi-pillar pension system where the primary role would be secured under the first pillar and additional risk-sharing guaranteed under the second. and third pillars;
- ensuring the transparency of the system by incorporating the point system (German example) into the first pillar;
- ensuring the political autonomy of the system by the automatic adaptability of the system (retirement conditions) to the new demographic challenges; and
- ensuring backup financing through the Demographic Reserve Fund.

3.2 Further Labor Market Reforms

Further labor market reforms should lead towards improvements in the system of labor market flexicurity and improve the efficiency of labor force allocation and reduce labor market segmentation.

The 2013 reform was an important step in liberalizing the labor market. To reduce pervasive labor market duality, the reform relaxed protection against individual dismissals and offered a mix of fiscal incentives and penalties to increase the relative attractiveness of open-ended contracts vs. temporary ones.

However, while duality was reduced immediately after the reform, this effect appears to have faded over time. The labor market situation has improved slightly in recent years after the strong deterioration during the crisis, however the main problem remains the segmentation of the labor market, despite changes relating to labor market regulation, since new jobs are mainly due to the growth of temporary forms of employment, which is reflected in the low employment rates for young and older people, and a large share of long-term unemployed.

Generally there are three, long-term particulars of the labor market in Slovenia where additional efforts and support of the government is needed.

The first one is the very modest employment rate of older people, which continues to be among the lowest in the EU, thereby undermining the long-term sustainability of the pension system.

The second one is the situation with the younger generation. Although the unemployment rate of young people has decreased in recent years, the issue of young people struggling to enter the labor market is a burning one. During the crisis, the increase in the unemployment rate of young people (aged 15–24) in Slovenia exceeded the EU average; the unemployment rate reached its peak in 2013 and, although remaining high, has been on the decline ever since.

The worsening of the situation of young people during the crisis was, in addition to the generally low demand for labor and the mismatch between the education system and the labor market's needs, also due to the fact that young people are more likely to be employed under temporary contracts (fixed-term employment contracts and student work). The reduction in the unemployment of young people in the last few years is attributed to the increased demand for student work, to the fact that the active labor market policy has focused more on young people, and to demographic trends. The persisting problem of young people struggling to enter the labor market is reflected in the still high unemployment rate and the proportion of people who are neither employed nor in education, which remains higher than before the crisis.

And the third specific is the high share of long-term unemployed in total unemployment, with every second unemployed person being unemployed for at least one year. The rate of outflow from unemployment, in the case of the long-term unemployed has begun to increase since mid-2014, but it is still quite high. In this context the objectives of the government should aim to:

- improve the situation of younger generations in the labor market, including those that are unemployed and not in education,
- increase the employment rate among the elderly (55–64),
- implement effective and adapted measures for the long-term unemployed, where emphasis is put on the elderly and persons with lower levels of education.

3.3 Improving Sustainability and Efficiency of the Health System

Slovenia is among the few CEE countries that preserved its public healthcare system with a single government owned and operated Health Insurance Fund (HIF) and limited private providers of voluntary health insurance services. The share of GDP spent for healthcare remained at the sustainable levels of below 7% of GDP – according to the Ministry of Finance's COFOG classification, its share of GDP has increased from 6,1% in 2008 to 6,6% in 2014 when the average of eurozone member states reached 7,3%. However there are problems within the existing healthcare system that call for an increase in efficiency in order to ensure sustainability. These problems are visible via the following indicators:

- long waiting lines delaying the provision of rights of the population ensured via the obligatory, centralized health insurance system (Health Insurance Fund – HIF),
- increased losses of healthcare providers due to the provision of services beyond programs ordered and paid by HIF,
- an implicit inefficiency due to the separated public procurements of medicine and medical equipment by individual healthcare providers and a dual system, as medical staff, especially doctors who work double shifts in public and privately run healthcare centers,
- the pressures of rising costs, due to both new medical technologies and those coming from the aging population.

To manage the healthcare sector Slovenia already started in 1998 with the World Bank healthcare sector mann agement project, aiming to improve healthcare sector efficiency. Despite a good initial start on the changes to the tasks and role of the HIF as the purchaser of services, reforms have stalled and the situation has worsen, at least when measured by the above indicators.

The healthcare sector reforms should aim to improve public healthcare, while considering its financial sustainability. The government needs to consider how to retain the rights provided by compulsory health insurance. There is a need to separate between public and private healthcare insurers while supporting competition among different healthcare providers. Whether one should abolish complementary health insurance should be judged against a proposal involving what it would be replaced with in order to ensure that funds collected via private sector health insurance funds remain in the healthcare sector.

But to ensure sustainability of the existing Health Insurance Fund and public healthcare providers further improvement in management practices are envisaged and should be implemented by authorities, including the following:

- implementing of a centralized and transparent system of public procurement in the healthcare sector for medicines, medical equipment and other equipment,
- improving in the management, operation and supervision of public health-care institutions,
- ending duality of employment in public and private healthcare providers,
- and last but not least improving the authority of the HIF's and healthcare providers' top management and their supervisory boards.

In order to manage medical costs related to the aging population, the government should act on two fronts. On one side there is a need to establish a comprehensive system for long-term care. This could include the possible conversion of some smaller hospitals into long-term care facilities and the provision of home based long-term care services, to be offered via regulated public and private sector providers. On the other side, there is a need to carefully manage long waiting lines, given the available funds and the rights of the population at large, along the most appropriate medical doctrines.

3.4 Public Sector Efficiency, Education, R&D and Science and other Developmental Policies

Slovenia's public sector efficiency is not yet high enough. There are some good practices (in Administrative Units), but also room to increase public sector productivity. This should boost the innovative capacity of the businesses, providing a business environment that fosters entrepreneurship, developing human capital supportive to the competitiveness of the economy and encouraging the more efficient use of digital economies. According to government documents, as of early 2017 there are 15 Government Strategic Development Projects (GSDP, see Table 1) aimed at improving the efficient use of public funds and providing better support to the economy at large.

As recently reported the Government has only concluded the project of Fiscalization of cash payments, ensuring a boost to fiscal revenues and implemented the process of VEM – All in One Place for the work Administrative Units, including VEM for Businesses. Others are still underway with an idea to be concluded or at least initiated within the mandate of this Government. Implementation of the above mentioned Development Projects would certainly increase public sector efficiency.

In the education sector the government should aim to improve the efficiency of higher education, and research activities. In higher education these should include the preservation and promotion of free university studies, under certain conditions. In primary schools the quality of education should be increased in order to improve the achievement of pupils. Given changes in society and the labor market, the government appropriately started with the introduction of more specialization via vocational training.

In general and similar to the healthcare sector, this Government envisages that there is a need for further reforms that would increase the education sector's efficiency by:

- reforming the promotion system and career development for school teachers and nursery staff,
- the professional development of primary and higher-education staff,
- reducing red tape with regard to managing schools and nurseries,
- and improvements in higher and primary education management and their supervisory boards.

Research and education sectors need to be further intertwined with private sector enterprises, fully utilizing available EU and private sector research funds. This is closely linked with further technolog-

Table 1: Government Strategic Development Projects (April 2017)

1. Energy renovation of Government and Local Community Buildings
2. Simplification of Public Procurement System and Establishment of Centralized Public Procurement System
3. Greening of Budget Policies
4. Reorganization of IT in the Public Sector
5. Fiscalization of Cash Payments and Complete Payments of Social Funds Contributions
6. VEM (All in One Place) in the Social Care Centers
7. VEM in Administrative Units to Acquire Permissions and Agreements
8. VEM for Businesses
9. VEM for Young Generation
10. System for Crisis Management and Leadership
11. Systematic Reduction of Debt and Coordination of Restructuring
12. Support of Social Entrepreneurship and Cooperatives
13. Renewal of Regulated Activities and Professional Jobs
14. Renewal and Optimization of Government Web Site
15. Centralized Management with Government Real Estate

ical development changes, where the Government plan and should promote the export orientation of companies and Slovenia's international competitiveness by:

- promoting Slovenian value chains and their inclusion into global value chains,
- promoting inward and outward investment,
- the formation of business clusters and networks enabling more effective entry to foreign markets.

3.5 The Absorption of EU Funds and Pan-European Investment Programs

For Slovenia, the absorption of EU funds is one, seldom, additional resource that when fully utilized it can positively influence the overall economic situation, measured with the net position in relations between Slovene and the EU Budget. For these reasons it was important to negotiate for MFFs 2004–2006, 2007–2013 and for the current MFF 2014–2020 the best possible starting position in relation to the net position, linked with the available agriculture and accessibility of cohesion funds.

However, once the MFF 2007–2013 had to be implemented it took up to 2009 to achieve a net positive outcome of some 155,6 million euro (see report of Ministry of Finance at www.mf.gov.si) after a negative net outcome of −68,7 million euro in 2008 and of −8,6 million euro in 2007. By the end of the MMF 2007–2014 the situation had improved as Slovenia gained a net positive result of as 509,3 million euro in 2013 and 633,3 million euro or 1,7 % of GDP in 2014 and a comfortable net position of some 445,9 million euro or 1,2 % of GDP in 2015.

Currently there is a similar situation in the MMF 2014–2020, as the net position of Slovene and the EU budget dropped to 40,3 million euro or a mere 0,1% of GDP. The situation of the delayed implementation of EU expenditures continued also in the first four months of 2017. It seems that halfway through the current MFF Slovenia has not been advanced enough in the utilization of available funds.

Despite the fact that the EU and EMU provide plenty of instruments that could boost government and private sector led investments, Slovenia as a small open economy with a highly decentralized absorption capacity at the ministry and fragmented, local community levels has difficulties in the timely and full absorption of available EU funds.

Furthermore, Slovenia has within the current Multi Financial Framework difficulties in acquiring available funding from the EU Budget and from International Financial Institutions as well as for projects that could have been funded under EFSI1 or EFSI2 schemes. As discussed earlier, difficulties with the utilization of available EU funds under newly established EFSI1 and EFSI2 funds could be critical should in the financial perspective of 2020–2026 financial engineering instruments become modus operandi of the EU's cohesion policy. Up to today Slovenia is among those EU countries where no significant EFSI project have started yet.

It would be critically important to fully and efficiently utilize potential and available financial, advisory and catalytic support of the International Financial Institutions on all levels: state, local and the municipality level, as well as on the level of public, state owned companies, and on the level of financial intermediaries and especially on the level of private corporations.

The fact is that IFIs are not (yet) sufficiently active on the level of public and especially private companies. Only most recently, has the EBRD returned to Slovenia with a regained, but limited presence and become more active in three strategic areas: a) corporate sector restructuring, expanding the role of the private sector and promoting good governance, b) stabilizing the financial sector and c) supporting sustainable energy. EIB has become more active and just recently opened its Resident Office. It's operation should in the coming period support some major capex operations in the railways sector as well as new railways link toward the Port of Koper.

3.6 Banking Sector Structural Reforms

To unleash private sector potential, Slovenia should conclude the restructuring of the banking system by completing NPL resolution and encouraging viable banking business models, given the low interest rate environment. In the medium term this should safeguard the medium-term financial stability and support growth. With the recapitalization of banks and the transfer of bad assets to the Bank Assets Management Company (BAMC), Slovenia was able to reduce the NPL ratio rapidly since late 2013. However, SME NPLs which are at some 13.4 percent of total SME loans as of the end of 2016 remain a major issue that needs to be resolved, should the financial institutions continue their business relations, with indebted, but otherwise healthy enterprises.

Banks are now adequately capitalized and liquid, and have increased profitability in recent years. But, the banks' net interest income came under major pressure due to:

- high-interest assets maturing and being replaced by low-interest ones,
- demand for domestic bank loans growing only modestly, and
- while deposit interest rates are already near zero.

There is also competition from the non-bank financial sector demanding a reassessment of the banks' business models. Not just in Slovenia, but within the EU at large, there is a need for further bank consolidation. This should include the separation of banking deposit/credit from investment banking business in order to reduce risks exposures. Further cuts in operating costs and finding new income sources should also be envisaged.

3.7 Further Enterprise Restructuring and Improved Corporate Governance of SOEs

Given the relatively low level of SOE profitability (which has nevertheless increased in recent years) there is a room for further enterprise restructuring and their improved corporate governance. This should ensure appropriate returns for the government related purposes, including those related with the aging population.

After the independence Slovenia immediately implemented specific privatization that ended with a mix of private ownership and SOE controlled via the government's controlled Restitution Fund – established as SOD and now known as SDH and (Pension) Capital Fund – now known as KA! which each received 10 % of the old social ownership structure. Despite these low numbers of the two government owned funds, the rest of the ownership have been decentralized, the government funds influenced a relatively high set of enterprises in infrastructure as well as in manufacturing. This is a distinct feature of Slovenia compared to other CEE countries, but we find a similar ownership structure in many countries of the European Union. The absence of complete privatization of a fire-sale type and government interventions during financial crisis resulted into a relatively high level of SOE banks.

The government undertook obligations to strengthen SOE corporate governance and to ultimately privatize banks that had received state aid, as well as some other non-vital manufacturing enterprises. In this context, a sustained privatization effort and improved governance are expected to improve both SOE governance and raise the economy's productivity.

It is thus expected that this Government will continue with the privatization processes that will be monitored, and based on a strategy and the classification of investments, judged on a case-to-case basis through clear criteria considering the social and economic effects of individual cases.

In the view of the IMF this effort should include significant revisions in the strategy for SOE management passed in 2015. The current strategy classifies SOEs managed by the Slovene State Holding (SSH) into "strategic" (majority state ownership), "important" (the state retains a 25 percent stake that allows for control in important decisions), and "portfolio" (full control is ceded to private owners), with the latter only a small fraction of the total SSH portfolio by value.

It is logical that the IMF recommends significant reduction of the number of companies classified as "strategic" and "important", especially in sectors like manufacturing and tourism, which are best left to the private sector, but which have ended up in government hands due to financial sector restructuring programs.

However finding appropriate buyers for the right price for chains of hotels at unique locations in Bled and on the Slovene Coast have proven difficult. Even selling some manufacturing companies like the paint company Helios or precise technology producer Fotona have been post festum assessed as fire sale due to the huge profits acquired by the intermediate foreign owner instead of the initial seller.

Thus there is an opposition to a recommendation like stepping up the sale of companies currently slated for privatization, including the 25 SOEs prepared for sale in 2016 and the remnants of the 2013 list, including *Telekom Slovenije*.

As the Slovene State Holding is also under personnel pressures and seems to lack independence from political interventions, the privatization of the remaining enterprises demands discussion and agreements on the key objectives, and professionalism in the management of the remaining companies. The fact that currently the SSH manages some 12 billion EUR or 1/3 of GDP worth of the Republic of Slovenia's ownership with some 140 million EUR of planned proceeds from profits into the Slovene Budget in 2017, shows the size and importance of upgrading and ensuring the sustainability and efficiency of the SSH Corporate Governance.

To conclude, as in other countries where ime proved SOE governance was achieved, efforts should be aimed tp:

- ensure the independence of the boards nominees and building their skill set,
- the provision of clear powers to nominees when they exercise individual SOE corporate strategy and develop the appropriate accountability of those nominees,
- and enable the development of truly independent directors that adequately remunerated for the job done, ensuring the full implementation of each individual company's strategy.

In these circumstances SOEs would also present a vital, profit making part of the economy in individual sectors or in monopolistic infrastructure areas.

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A Coherent Growth Policy for Macedonia

Dragan Tevdovski

Executive Summary

- Macedonia implemented a neoliberal economic model through the transition process. It is characterized by the reduction of workers' rights, the destroyed power of trade unions, the existence of flat and low taxation, the glorification of the foreign direct investments (FDI), and the progressive replacement of the public health and educational system with a private system. This model failed to achieve productivity, growth and solutions for unemployment, while it increased the income inequality in the country.

- A wage-led growth strategy could be a solution for the economic development of Macedonia. It is opposite than the two dominant neoliberal strategies: export-led growth and debt-led growth. Moreover, there is a need for the introduction of fair taxation and the need to re-build the social safety net. The EU should start to promote elements of the famous European social market model through the country's integration process.

- The European Commission in its latest report about Macedonia used the term: "captured state". The first step towards the deconstruction of the abused institutions by the political elites is fiscal transparency. It should be accompanied by the liberation of the control mechanisms over the people in power: a strong parliament, a depoliticized police force, an independent judiciary, a free media and a powerful civil sector.

1. Introduction

Macedonia is the country with highest income inequality in South-Eastern Europe (SEE). Table 1 presents the GINI index for selected SEE countries. The high income inequality has transformed the Macedonian society in one the resembles those in Latin American. This is the reason why the many reforms in the country in the past twenty five years have not significantly improved living standard.

Macedonia implemented a neoliberal economic model through the transition process, while the EU did not show interest in promoting the famous European social market model through the country's integration process. Its most important elements are: the reduction of workers' rights in the legislation, the destroyed power of trade unions, the existence of flat and low taxation, the glorification of the foreign direct investments (FDI) and the progressive replacement of the public health and educational system with a private system. This model failed to achieve productivity, growth, and a solution for unemployment. In addition, the redistributive mechanisms in the society – taxes and social transfers do

Table 1: GINI index

Country	First year of World Bank's estimates	Last year of World Bank's estimates
Macedonia	28 (1998)	44 (2008)
Bulgaria	31 (1992)	36 (2012)
Bosnia and Herzegovina	30 (2001)	34 (2011)
Croatia	29 (1998)	32 (2013)
Montenegro	30 (2005)	32 (2014)
Serbia	32 (2002)	29 (2013)
Albania	27 (1996)	29 (2012)
Slovenia	29 (1993)	26 (2012)

Source: World Bank (2017)

not contribute towards decreasing inequalities. The tax burden is significantly lower than the EU average, while the funds collected with the low and flat taxation does not contribute in the development of adequate social systems. As the result, the social protection schemes can not provide an exit from poverty for the majority of those citizens in need.

Institutions are weak and completely dominated by political elites. Their immanent characteristic is one of insufficient fiscal transparency. The system of democratic control (judiciary, parliament, media, etc.) is ingested in political patronage. The European Commission used the term "captured state" when describing the situation in Macedonia.

The rest of the paper is organized as follows. Section 2 provides brief chronologic overview of the economic development of Macedonia since transition. Section 3 presents the most important element of the installed neoliberalism and its results. Section 4 discusses the need for a wage-led growth strategy for Macedonia. Section 5 provides the key elements of the Rehn-Meidner model which was successfully applied in Sweden. Section 6 analyses the changes of the tax system and social transfers towards achieving a better redistribution of income in society. Section 7 presents the problems of the "captured state" and propose solutions for it's liberation from the claws of the political elites.

2. Brief Overview of Macedonia's Economic Development

Macedonia gained independence in 1991 without participation in the Yugoslavian wars, but it was not immune to the economic problems wrought by the dissolution of Yugoslavia. In the mid-1980s, the economy of the former Yugoslavia descended into a deep recession that included high international indebtedness, high inflation that turned in hyperinflation, and high unemployment. The wars in 1990s cut the strong economic ties between the former republics.

The period from 1991 to 1995 is characterized by start of the privatization process, sharp economic decline, hyperinflation, and the presence of two external shocks. The privatization process did not take care to preserve the country's economic and social productive tissue and as a result, created massive layoffs. Real GDP was reduced by more than 25 % in the period from 1991 to 1994. The fall of real GDP was accompanied by extremely high rates of inflation: 1,639 % in 1992, 362 % in 1993, and 128 % in 1994 (Petrevski, 2005). At the same time, the United Nations' sanctions against Macedonia's northern neighbor, Serbia (1992–1995), and the trade embargo imposed by Greece (1994–1995), created large scale isolation of Macedonia's economy. During this period, macroeconomic stabilization was the only priority of the country's economic policy. A stabilization program was introduced in 1992, characterized by a slowdown in monetary expansion, a tightening of fiscal policy, and limiting the credit expansion of state enterprises. As a result of the program's implementation, Macedonia achieved a satisfactory level of macroeconomic stability, but the unemployment rate reached 35.6 % in 1995.

The policy of macroeconomic stabilization, together with the process of privatization, continued in the period after 1995. Inflation continued to decline, even deflation of 0.1% occurred in 1998. Real GDP grew, reaching 4.5 % in 2000. The main sources of growth were industrial production and domestic consumption. However, the positive trend in Macedonia's economy ended in 2001, as a result of internal conflict. The conflict reduced economic activity and created a significant increase in budgetary spending for security purposes. The crisis affected all the economic sectors. In the period from 1998 to 2002, GINI index grew dramatically, from 28 to 38.

The period around 2002 was a period of economic recovery. The economy grew by an average rate of 3.6% in the period from 2002–2006. However, the growth of the economy failed to solve the key problems of the country: high unemployment and poverty. The unemployment rate peaked at 37,3% in 2005.

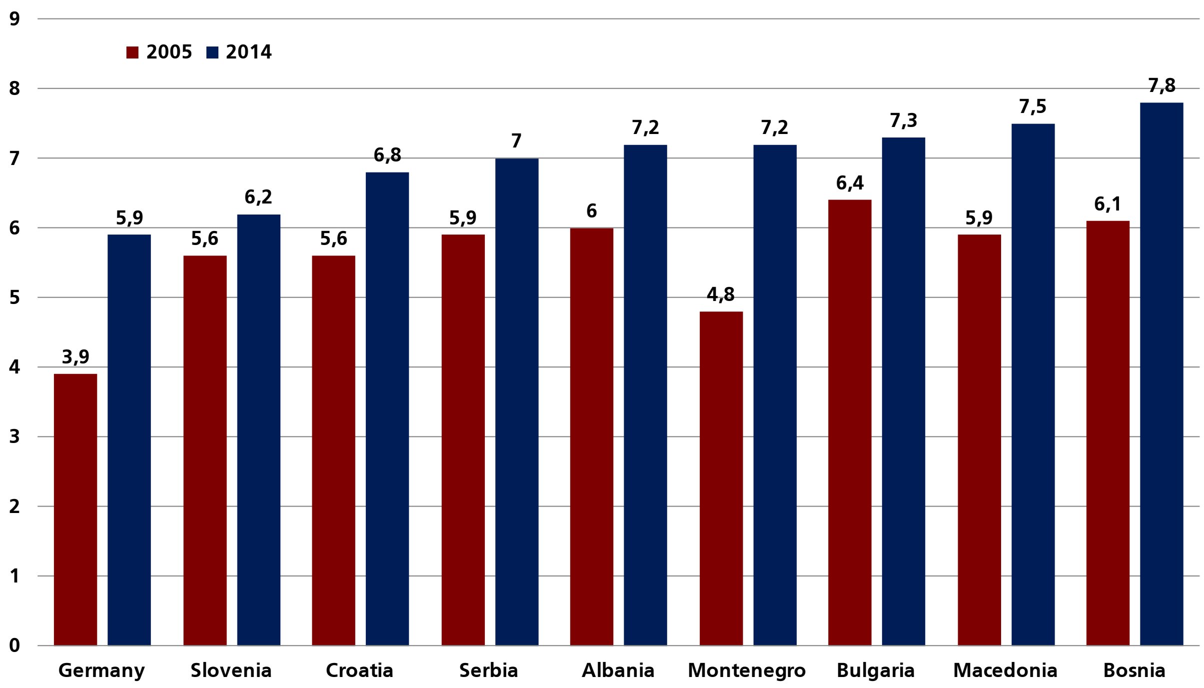
The economic reforms that started in 2007 led to a strong installation of neoliberal elements in the economy: flat and low tax rates, a reduction in workers' rights through legislation, and the glorification of foreign direct investments (FDI). However, Macedonia's economy started to feel the consequences of the Global financial crisis in the end of 2008. The economy entered a recession in 2009, had a low positive growth rate in 2010 and 2011, and again entered recession in 2012. This last period was also characterized by a slow-down in the country's integration process in NATO and the EU as the result of the name dispute with Greece, where the right-wing country's government responded with a rise of nationalism and undertook a massive project of building monuments, museums and administrative buildings (Tevdovski, 2015).

3. The Failed Neoliberal Elements in the Economy

The installed program of neoliberalism can easily be recognized in the Macedonian economy. The most important neoliberal elements installed in the country are: the reduction of workers' rights in legislation, the destroyed power of trade unions, the existence of flat and low taxation, the glorification of foreign direct investments (FDI) and the progressive replacement of the public health and educational system with a private system.

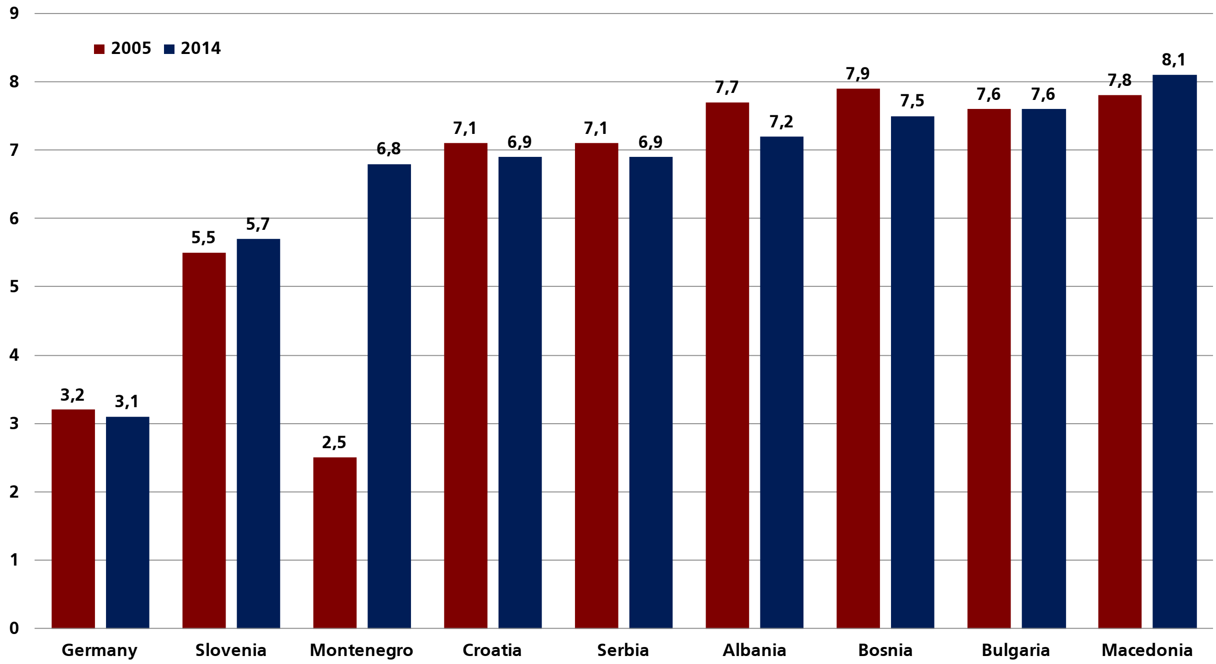
The first element is the reduction in workers' rights through legislation. Figure 1 compares the indices of labor market regulation in 2005 and 2014 in South Eastern European countries (SEE) and Germany as a benchmark. The range of the index is from 1 to 10, where 1 means that the labor market is strongly regulated and 7 means that the system is flexible. The values of the index increased in all countries during the observed period. It implies that the regulation of the labor markets have deteriorated and are not sufficiently protecting the rights of workers. Moreover, Macedonia together with Bosnia and Herzegovina has the highest value of the index which is opposite to the case of Germany.

Figure 1: Index of labor market regulation



Source: Economic Freedom of the World (2016)

Figure 2: Index of collective wage bargaining



Source: Economic Freedom of the World (2016)

The second element involves the destruction of the power of trade unions. Figure 2 presents the index of collective wage bargaining in SEE countries and Germany as a benchmark. The index values range from 1 to 10, where 1 means that the wages in the country are fixed through the collective bargaining process and 7 that wage fixing does not depend on this process, but on individual firms. Macedonia had the highest value of the index in 2014. Again it is on the opposite side of the distribution from Germany. It implies that there is a lack of collective bargaining process in Macedonia. Moreover, the increase in the value of the index means that the collective bargaining process has worsened further in the period from 2005 to 2014.

The third element: flat and low taxation. Macedonia introduced a 12 % flat personal income tax and a corporate profit tax in 2007, which later on, in 2008, was cut to 10 %, which is the current value. It was the part of the SEE countries race to the bottom, which started a decade later than in Central and Eastern Europe (Estonia, Lithuania and Latvia introduced flat taxation in 1995). In January 2007, Macedonia introduced a 12 % flat personal income tax and corporate profit tax, which later on, in 2008, was cut to 10 %, which is the current value. In the same time (January 2007) Montenegro introduced a 15 % flat personal income tax, whose rate dropped to 12 % in 2009 and finally since 2010 it has been decreased to 9 %. Montenegro has also introduced a 9 % flat corporate profit tax. Albania in 2008 followed the Macedonian and Montenegro example and implemented a 10 % flat tax on corporate profits, whereas later in 2014, Albania returned to a progressive personal income tax. Bosnia and Herzegovina and Kosovo introduced a 10 % flat personal income tax in 2009. The personal income tax rate in Serbia depends on the type of income, while all companies in Serbia are subject to a 10 % flat corporate tax. Only Slovenia and Croatia never accepted flat taxation.

The existence of flat and low personal income tax and corporate profit tax in Macedonia, together with low property taxes, does not contribute in correcting the inequality of income distribution. On the contrary, it does the opposite – it favors the flow of income towards the rich in the interest groups in the society. Therefore, the state budget in Macedonia is largely comprised of revenue from the value added tax, in which case the poor pay higher taxes as a percentage of their disposable income than wealthier individuals.

The fourth element: the glorification of FDI. In Macedonia, the policy makers present FDI as a 'holy grail' for the economies and the basis for economic development, although, they never present any cost-benefit analysis on the effects of FDI in the country. On the cost side, the state provides different types of privileges for FDI in technological industrial development zones: a 0 % corporate

Table 2: Selected macroeconomic indicators

Country	FDI, average 2008–2015 (% of GDP)	Unemployment, average 2008–2015	Total growth rate of GDP per person employed, 2008–2015
Macedonia, FYR	3.5	30.4	2.6 %
Albania	9.1	14.8	34.5 %
Bulgaria	6.0	10.0	18.8 %
Montenegro	17.9	18.7	16.4 %
Bosnia and Herzegovina	2.5	26.4	11.5 %
Serbia	6.1	19.3	11.2 %
Slovenia	1.2	7.9	5.6 %
Croatia	3.6	13.7	–0.8 %

Source: World Bank (2017)

tax rate up to 10 years, a 0 % personal income tax for up to 10 years, a 0 % value added tax for goods, raw materials, and equipment; an exemption from the payment of customs duties for equipment, machines and spare parts; an exemption from paying utility taxes to the local municipality and fees for building permits; and the state is providing up to 500.000 euros in the construction costs of the investor in the zone (Directorate for technological industrial development zones, 2016). Moreover, the policy of attracting FDI is not transparent and the state has never published even the total amount spent on FDI. With this policy of attracting FDI there are problems regarding the transfer of knowledge and skills and the multiplying effect for the economy. Except for opening of low paid jobs, generally, there is no transfer of new knowledge and skills, because most of the cases refer to work on production lines. Also, there is almost no multiplying effect of the foreign investments in the economy due to poorly established links between domestic companies and foreign investments.

The fifth element is the destruction of the public services. The pillars of the society – the public health system and education system, have been progressively destroyed as their replacement with private sector continues.

What were the proclaimed goals of the introduced neo-liberal elements? The increased flexibility of the labor market, along with the reduction of salary contribution rates was intended to reduce administrative barriers and salary burdens in order to increase the number of new jobs in the economy. The low and flat taxes were intended to makes the economies havens for investment. FDI was intended to inject new capital and to bring new technologies, knowledge and skills, which would have increased productivity and accelerated economic growth. However, Table 2 shows data on FDI, unemployment, and labor productivity in the selected SEE countries from 2008–2015. The average net inflow of the FDI in Macedonia (3.5 % of GDP) is the third lowest in the SEE region. The neighbor countries of Macedonia – Albania, Bulgaria and Serbia achieved better results in terms of attracting FDI as a percentage of GDP. The average unemployment rate in Macedonia (30.4 %) in the observed period is the highest in SEE. All other SEE countries, except for Bosnia and Herzegovina, have a lower unemployment rate by at least 10 percentage points than Macedonia. Also, the total growth rate of GDP per person employed in Macedonia is the second lowest in the SEE region. The growth of 2.6 % over a 7 year period implies that labor productivity is almost stagnant. Macedonia's neighboring countries have a growth of labor productivity of at least four times higher in the observed period: Serbia (11.2 %), Bulgaria (18.8 %) and Albania (34.5 %).

So, who gets and who loses from the introduction of the neoliberal elements in the Macedonian economy? The winner is the rich interest group in society, while the price is paid by the majority of the population. Why? The flexibility of the labor markets and the destruction of collective bargaining removes the protection from the workers and keeps wages at a miserably low level. This makes profits high while the flat taxation does not provide for the redistribution of income from the wealthy towards all others in the society.

4. The Need for Wage-led Growth Strategy

Wage-led growth is a completely different strategy than the two dominant neoliberal strategies: export-led growth and debt-led growth. The export-led growth strategy domineered the world from the end of the 70s during the past century. It was based on the idea to develop the production capacities in the economy in order to conquer foreign markets. The Asian Tigers: South Korea, Taiwan, Hong Kong and Singapore are the best example of countries which put this strategy in place. In Macedonia, despite the continuous debates about the development of domestic capacities for export, no significant progress was made. With regard to this strategy, the only consistent policy was to attract foreign investments that provide for export products from Macedonia.

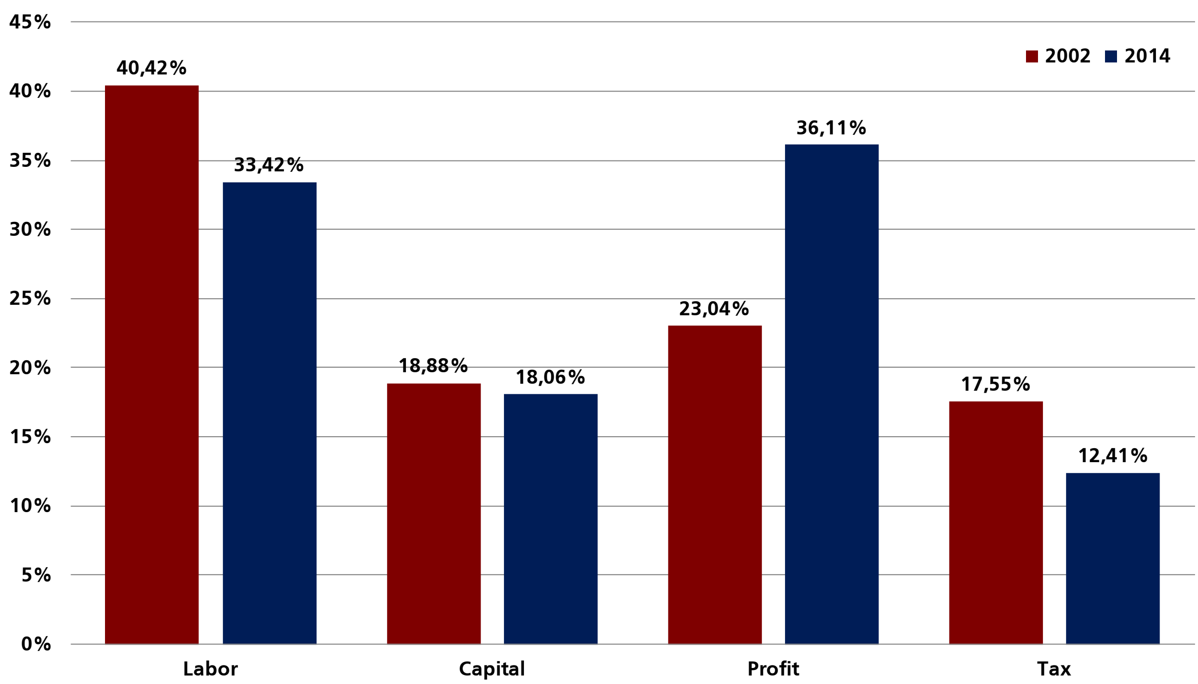
The debt-led growth strategy was applied in Macedonia over the past eight years. In 2008, public debt accounted for 23.0 % of GDP, which, at present time, accounts for 50.6 % of GDP. Moreover, the public debt is much higher compared to the figures from the Ministry of finance, because it does not include the National Bank's debt, non-guaranteed debts of public enterprises and incurred, but unpaid liabilities of the state.

The problem with this strategy is that it can provide convenience for a certain number of years (even when money is not spent properly), but then one becomes dependent on the strategy. These two strategies, together with the basic package of neoliberal measures, increase the profit gained by the small groups of interest in the society, while increasing the dependency of the majority of people on debt led growth.

Figure 3 shows Macedonian GDP according to the income method. It provides the market price of all products and services in the economy as a sum of the labor price, capital amortization, firms' profit and taxes on products. In 2014, firms' profit accounted for 36 % of the market price of all products and services created in Macedonia. The share of profit increased dramatically in the observed period, since it accounted for 23 % of GDP in 2002. Contrary, the share of labor (the total price that firms pay to their employees: salaries, taxes, contributions, food and transport allowances, fieldwork allowances, annual leave allowances, etc.) in GDP has significantly declined from 40 % in 2002 to 33 % in 2014. The share of capital depreciation in GDP remained unchanged in the period from 2002 to 2014 and accounts for around 18–19 % of GDP.

The wage-led growth strategy is based on two ideas. First, the growth in salaries will cause people to spend more, which in return, increases the demand in the economy. This idea is contrary to the neoliberal economic thought, which considers salary only as expense for companies, i. e. an increase

Figure 3: GDP, income method



Source: State Statistical Office of the Republic of Macedonia (2016) in salaries means an increase in the price of production factors, which further results in lower interest for investments in companies. This argument was refuted by Keynes in the 1930s, with the following question: "As long as every company wants to pay lower salaries to its employees, it is unclear whether the companies want to reduce the general salary level, because that will have an impact on the demand for their products?" The logic, indeed, is that salaries are both sources of demand and factor pricing.

Second, the wage-led growth strategy is focused on productivity. It's quite clear that a well paid worker will be more satisfied and ensure quality in the performance of work. In addition, growth in salaries will pressurize the company owners to give more consideration to productivity in order to protect their profitability. They will be forced to improve the production processes and invest in the improved knowledge of employees, but also, to dismiss unproductive workers. In return, it will increase the productivity of the economy.

The strategy to increase salaries in Macedonia may start by increasing the minimum wage and providing state support to domestic companies that open jobs with a higher than the average salary. However, such changes would require that employees are better organized when they negotiate the salaries. The success of this strategy, in the long run, will depend on the reforms in the educational system, because workers' knowledge and skills are the basis for their salary.

School reform should be mainly directed to reduce the number of subjects, and the students should be focused on a lower number of relevant disciplines, such as mathematics, languages, literature and computers. It differs from the current practice of indulging in all disciplines, while being ignorant in basic disciplines. In order to ensure successful changes, on one hand, we need to lay down a strict criteria for the eligibility of teaching staff, and on the other hand, to increase teachers' salaries. Another important aspect of the reform should include vocational training. It is nonsense that everyone should enter the university to obtain an academic education. The country should follow successful examples, such as the German one, in the design of adequate vocational training programs.

Technology is the next factor that besides the worker's knowledge and skill, also determines productivity. Until now, the state did not opt for supporting the business with added value, but quite the opposite, major state support was provided to businesses that are based on work on production lines. However, that presents another major opportunity. The focus should be placed on the state incentives for businesses using advanced technologies. That would stimulate the growth in salaries.

5. A Successful Example: Rehn-Meidner Model

The Rehn-Meidner model is unknown to the Macedonian public. However, it has been successfully applied in Sweden since the 1950s. This model was designed by two economists from the Swedish confederation of trade unions, Rudolf Meidner and Gosta Rehn. In 1951, they published a macroeconomic model, which constitutes a third way and differs from Keynesianism and monetarism. The idea is to realize the four objectives of the economic policy (full employment, low inflation, income equality and economic growth) through the combination of restrictive macroeconomic policy, a solidarity policy of salaries and a selective policy for the labor market.

The model recommends a tightened fiscal policy (mostly through indirect taxation) and monetary policy to keep the inflation low during the business cycle, which is more than the recommendation for fiscal restrictions during full employment according to Keynesian theory. His idea is to limit the aggregate demand in order to prevent the overheating of the economy and periods of a massive increase in expenses. It does not exclude the expansive fiscal policy in periods of low economic activity.

Restrictive macroeconomic policy, not only aims to control inflation, but also to pressurize the reduction of profits and profit margins, while income distribution is made in favor of labor. Therefore, full employment cannot be achieved through expansive macroeconomic policy, as it is construed by the Keynesian model, but through selective employment policy.

The policy of solidarity for salaries means equal pay for equal work, irrespective of the company's profit. It includes two objectives. First, create a more equitable structure of salaries in the economy by ensuring equal salaries for equal work. Second, to pressure companies to increase productivity. The policy of solidarity for salaries prevents the survival of companies only by paying low salaries. Therefore, it is also an instrument that "kills" unproductive companies and pressures their transformation. Growth in productivity is the most important factor for the growth of salaries.

The policy for the labor market should address unemployment, which may be created due to the generally restrictive macroeconomic policy and policy of solidarity for salaries. It consists of two parts: a selective policy of demand and measures to improve the adjustability of the labor market. The policy of labor demand should have the least possible effects on the aggregate demand, and therefore should be oriented only towards individuals, groups and regions confronted with problems. Rehn and Meidner, also recommend marginal employment subsidies. The adjustability of the labor market should improve through offered oriented measures (training grants and vocational education programs) and an adequate matching of the offer and demand on the labor market by the public employment agencies.

The idea of this policy is to ensure the worker's adjustment and mobility to new jobs. This would stimulate the economic growth by facilitating the productive companies to recruit workers. Furthermore, the policy for the labor force is also an instrument to fight inflation. Stimulating workers' mobility alleviates the possibilities for salary growth in the sectors that have a larger demand for labor. However, it does not necessarily mean that the policy of the labor market leads to lower salaries. It prevents unemployment, which in return, prevents the reduction of salaries in a recession.

The policy for the labor market has an essential role in securing equality. Worker's mobility in the labor market prevents major differences in the salaries among companies. In addition, the policy of solidarity for salaries accelerates the shift of workers from non-productive to productive sectors. Securing full employment can also increase the equality of income distribution in the society, which enhances the share of labor in the added value of the economy.

In the middle of the 1970s, when neoliberalism started to restore its power, Meidner added another element to this model: the "funds of those who work for salary". Meidner proposed that one part of a company's profit be placed in a fund, which is managed by the trade unions. His idea was to retain the power of the trade union movement and reduce the power of capitalists. Meidner's proposal, represents the biggest ideological confrontation among the social democrats and the liberals in Sweden.

6. Introduction of Fair Taxation and Re-Building of the Social Safety Net

Piketty (2014) concludes that inherited wealth is more important than effort and talent. He shows that the capital return rate significantly exceeds the rate of economic growth in the last 140 years in the developed countries, which means that wealth is concentrated in the hands of a few people, who earn a lot more than the people who work on an everyday basis and earn a living from their labor.

Inequality in the distribution of economic results leads to major inequality in opportunities for future generations. The 'winners' of today, unfairly transfer the major advantages to their children in the future. They can pay the high tuition for schools and universities, health services in private hospitals, leave large estates and shares to be inherited by their children, which enables them to have an advantaged start in life when compared to others.

Macedonia has the highest income inequality in the SEE region. There is no available data about wealth inequality. However, prolonged high income inequality leads to higher accumulation of the wealth only in few hands. The public health and education systems are being progressively destroyed. There is an increasing need to go to private hospitals, while tuition in private primary and secondary schools can be as high as several thousand euros. It has become far beyond the reach of the middle class – people who do not own companies, and earn a living from their labor.

Macedonia should introduce re-distributional policies that will target the growing inequalities in incomes and wealth. The set of measures should include progressive taxation, the correct identification of citizens' wealth and the re-building of the social safety net.

The changes towards a more progressive taxation should be made gradually, in parallel with improvement in the efficiency of state institutions, because the taxation is a balance between the imperfection of the market and the imperfections of the institutions. The flat tax should be replaced with the progressive personal income tax. The property tax should receive some form of progressive taxation, such as that seen in the case of Slovenia. In Slovenia, the tax rate for property of value higher than 500 thousand Euro was increased for 0,25 percentage points. At the very start, in Macedonia the tax rate for a luxurious property can be increased for 0,1 percentage point. This means that individuals who live in a house worth more than 501 Euro will pay property tax of 750 Euro, and not 250 Euro as it is currently.

The correct identification of citizens' wealth is a key condition for fair taxation. On the national level, as well on a regional level, platforms for determining citizens' wealth should be developed. They should include personal assets, including owner-occupied housing, cash, bank deposits, money funds, savings in insurance and pension plans, investment in real estate, corporate stock, financial securities, cars, yachts and artwork. The correct identification of citizens' wealth is the first step towards a more sophisticated taxation on wealth.

The social safety net should be rebuilt. The process of the privatization of public services should be stopped, and instead focus their efforts towards the increase of their quality and efficiency. The first steps in the reform process should be focused on the programs designed to provide social fairness in the society, such as an adequate minimum wage, a minimum income scheme and youth guarantee.

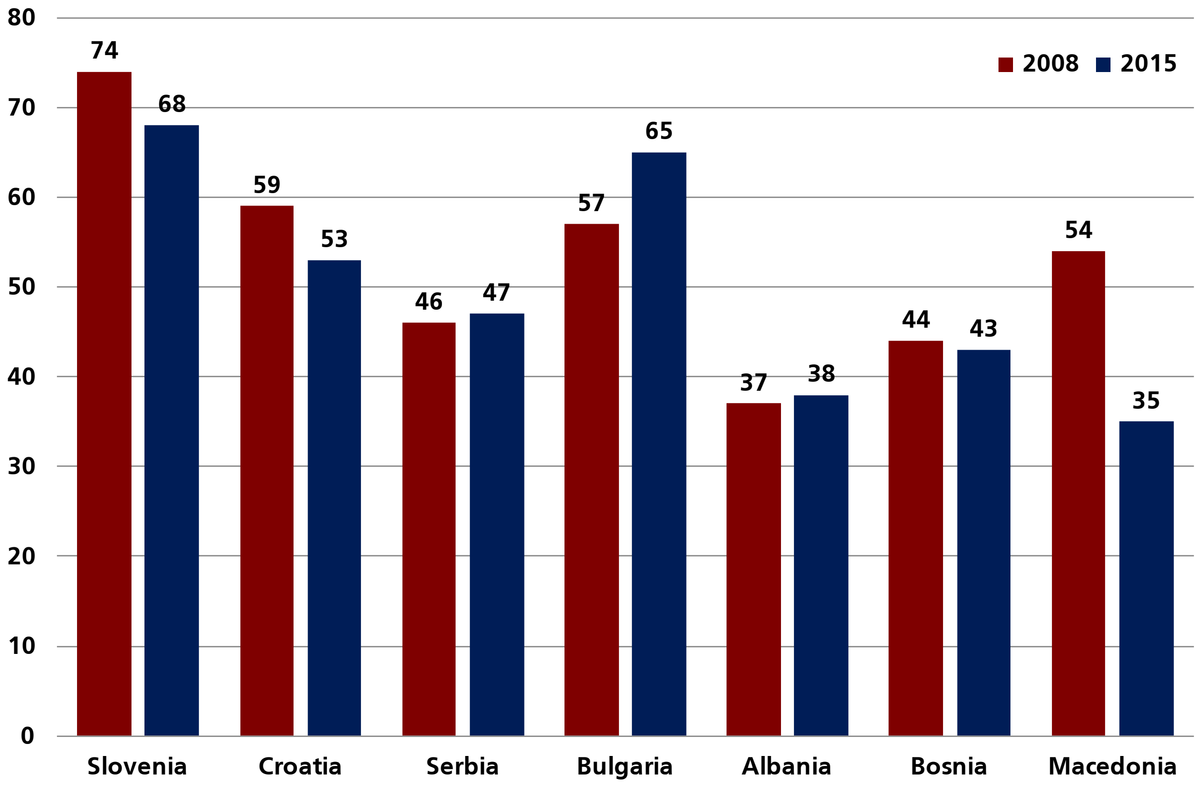
7. Towards the Release of Captured State

The European Commission in the latest progress report about Macedonia stated: "Democracy and rule of law have been constantly challenged, in particular due to state capture affecting the functioning of democratic institutions and key areas of society" (European Commission, 2016). The separation between the state and the ruling party has been diminished. There is strong political party loyalty and politicization at all levels of power. The state's institutions are completely dominated by the political elite in power. Their immanent characteristic is the lack of transparency and accountability.

Figure 4 presents the open budget index for Macedonia and selected countries from the SEE region. The index uses a 100-point scale, where there are two levels: insufficient budget transparency (0–60) and sufficient budget transparency (61–100). The insufficient budget transparency contains three sub-levels: scant or none (0–20), minimal (21–40), and limited (41–60). The sufficient budget transparency contains two sub-levels: substantial (61–80) and extensive (81–100). Macedonia's budget transparency worsened in the period from 2008–2015. It is in the group of countries with insufficient minimal budget transparency and the country has lowest open budget score in the SEE region.

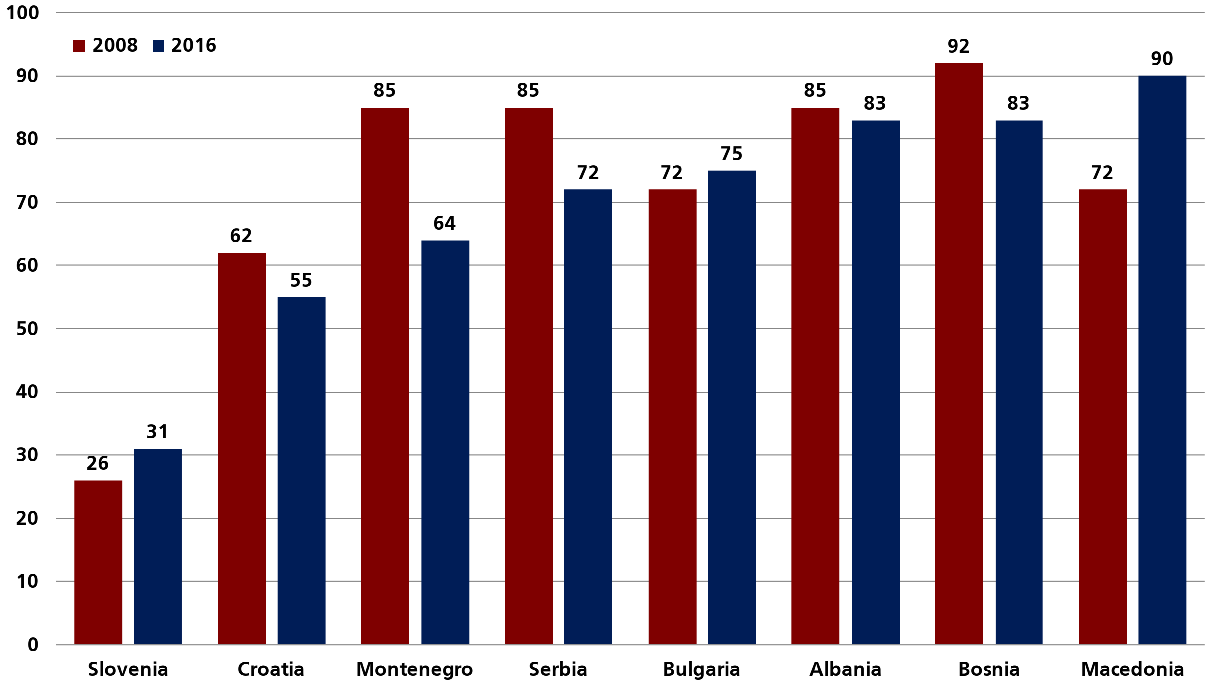
The lack of transparency and accountability allows the political elite to make crucial decisions outside of democratic forums and public scrutiny. It disables the citizens to have insight into the government process (e.g. decision making or budget spending) and to hold incumbents responsible. The result of this deficiency is almost unlimited opportunities for the ruling parties and their leaders to gain wealth from the abuse of state resources (Cenic et al., 2015).

Figure 4: Open Budget Index, Scores



Source: International Budget Partnership (2016)

Figure 5: Corruption Perceptions Index, Country Rank



Source: Transparency International (2016)

The Corruption Perceptions Index can serve as a proxy for the downgrading of institutional capacity in Macedonia. Figure 5 presents this index for Macedonia and selected SEE countries. Macedonia is the worst ranked from all SEE countries. It is in 90th place in the World in 2016, together with Zambia, Colombia, Indonesia, Liberia and Morocco. Moreover, Macedonia worsened in its ranking in the period 2008–2016, which is contrary to the majority of SEE countries who made progress in the corruption perception ranking.

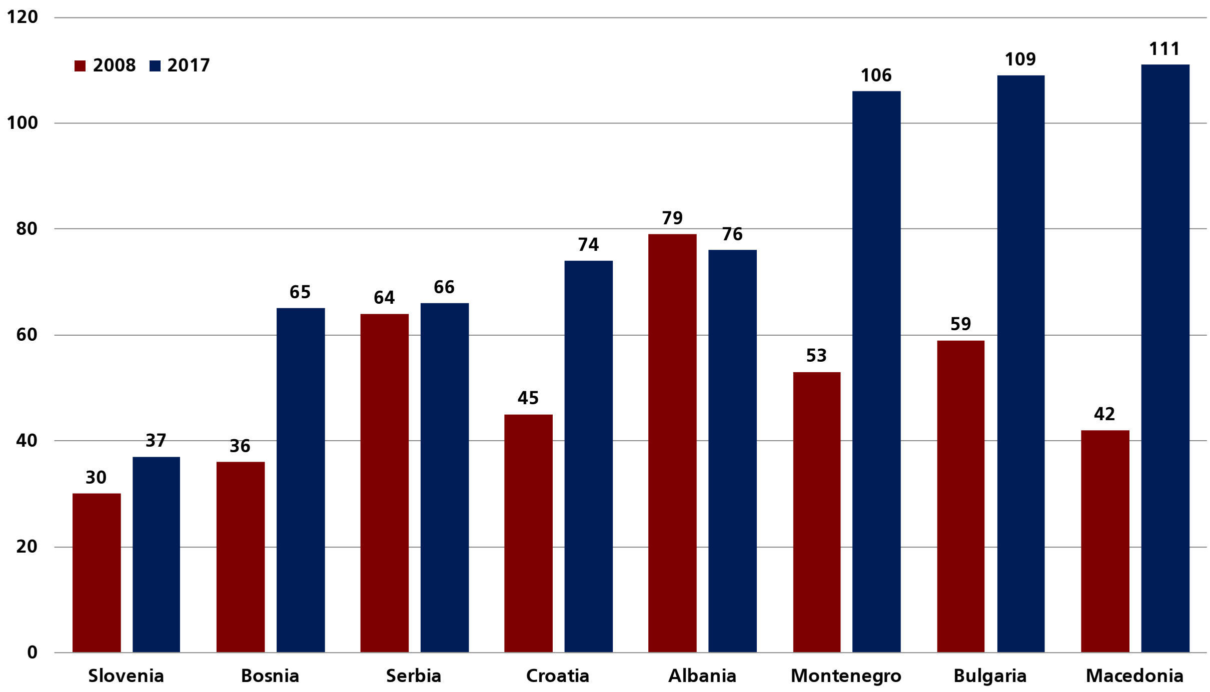
Political patronage is a tool that allows ruling elites to offer something to citizens in a situation when social protection is not adequate, the quality of the public services is decreasing, the wages and pensions are low, and the living standard is bad. Patronage links are being formed between voters belonging to specific social groups and ruling parties providing the redistribution of state related benefits in favor of these groups (Cenic et al., 2015).

The state related benefits can take different forms: (i) real income such as salaries and social transfers; (ii) privileged protection against market risks; and (iii) impunity from the law. The first type of the state related benefits is the main tool for the creation of the voting machinery for the ruling parties. Its most common examples are: hiring employees based on party membership, receiving a salary in public administration without having to go to work or at least a having a much greater commitment to political party activities, an increase in pensions before elections, and social transfers for people who do not qualify for them. The most common examples of the second type of the state related benefits are: the organization of tender procedure in order for the application requirements to fit only one company, preferential treatment for big companies, and subsidies in agriculture without concern for the achieved results. The most common examples of the third type of state related benefits are: tax evasion, unauthorized construction, pension fraud and legislative immunity.

The Macedonian case of the political patronage is not unique in the SEE region. There is a growing body of literature that deals with the political patronage in other SEE countries (Đukić 2006, Dobrotić 2008, Kajsiu 2010, Upchurch and Marinković 2011, Cvijanović and Redžepagić 2011, and Mavrikos-Adamou 2013). Moreover, Pappas (2013), argue that a political patronage system existed in Greece, the oldest EU member country from SEE, long before its transition in the 1990s. He highlighted this system as the main reason for the crisis in Greece (Tevdovski, 2015).

The main problem with political patronage is that it distorts and ingests the system of democratic control in the country. The judiciary, parliament and media are controlled by the political parties in

Figure 6: World Press Freedom Index, Country Rank



Source: Reporters without borders (2017)

power. For example, Figure 6 presents the World Press Freedom Index for Macedonia and selected SEE countries. Macedonia has shown a worsening of its media freedom in the period 2008–2017. The country was ranked on 42nd place in the World in 2008, while it fell to 111th place in 2017.

The first step towards the deconstruction of the abused institutions by the political elites is fiscal transparency. Complete transparency of the actions of the people in power will have to be secured. Spending the budget funds, both at the central and the local level, may not be concealed from the citizens any more. Every citizen will have to be able to access from their personal computer into the spending of the last dinar of the budget, and every politician must be crystal clear that the control over spending is not done by some committees (which are formed by the politicians), but that all citizens are the possible controllers of the money spent from taxation. In general, this element should include the so-called "active transparency" of the institutions, which implies the publication, without request, all decisions and documents that influence the life and work of citizens and companies.

Transparency should be accompanied by the liberation of the control mechanisms over the people in power: a strong parliament, a depoliticized police force, an independent judiciary, a free media and a powerful civil sector. Here are three examples that can bring about shifts in those who should be the correctors of the governing establishment. The number of parliamentarians needs to be reduced, and they should be elected through open lists in order to ensure that elected parliamentarians are strong enough and will not serve as a voting machine for political parties and politicians. The public prosecutor should be elected on proposal by the opposition in order to secure that he/she is not part of the governing team and is properly doing carrying out the work of her office. Spending funds from the central and municipal budgets in the media should be completely stopped in order to prevent the undermining of media by the government. Similarly, political advertising in the media should be completely prohibited, except for election campaigns under strictly regulated conditions.

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